United States Court of Appeals

FOR THE NINTH CIRCUIT

No. 12506

: Pacific Railroad Corporation and Alexis I. duP. Bayard, Receiver,

Plaintiffs-Appellants,

vs.

: Pacific Railroad Company, Sacramento Northern Railway, Tide-
outhern Railway, Deep Creek Railroad Company, The Western
Company, The Standard Realty and Development Company and
inance Co., Ltd.,

Defendants-Appellees.

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ith H. Metzger, Henry Offerman and J. S. Farlee & Co., Inc.,

Plaintiffs-Intervenors-Appellants,

vs.

: Pacific Railroad Company, Sacramento Northern Railway, Tide-
outhern Railway, Deep Creek Railroad Company, The Western
Company, The Standard Realty and Development Company and
inance Co., Ltd.,

Defendants-Appellees.

RIEF FOR PLAINTIFFS-INTERVENORS-APPELLANTS

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Date	
1916	Plaintiff acquires all of the stock of defendant $75,000,000.
1925	The James Interests acquire control of plaintiff.
1935	Defendant goes into reorganization.
1940	The District Court approves defendant's reorganizat plan.
1943	
Mar. 15	The Supreme Court affirms the approval of defenda reorganization plan.
June 1	Plaintiff's officers become full-time employees of defe ant, paid solely by defendant.
1944	
Jan.	Defendant decides to eliminate its taxes by using pl tiff's tax credit.
Apr. 30	Plaintiff transfers its stock in defendant to defenda reorganization committee.
July 15	Plaintiff files consolidated tax returns for 1943.
Dec. 29	Defendant emerges from reorganization.
1945	
Mar. 9	Plaintiff files the refund claim for 1942 taxes.
Apr. 30	Defendant closes the New York office; plaintiff's offi move to the suite of Whitman, Ransom, Coulson & Go
June 15	Plaintiff files consolidated tax returns for the first months of 1944.
1946	
June 26	Curry signs plaintiff's power of attorney in favor of F
June 27	Intervenors institute the New York stockholders' act
Oct. 10	Plaintiff institutes this action.
1947	
Feb. 11	Polk offers, in plaintiff's name, to settle the tax cor versy with the Government.
Apr. 2	Polk notifies plaintiff of this offer.
Aug. 13	The Government accepts the settlement offer.

United States Court of Appeals

FOR THE NINTH CIRCUIT

'ESTERN PACIFIC RAILROAD CORPORATION nd ALEXIS I. DUP. BAYARD, Receiver,
Plaintiffs-Appellants,

vs.

ESTERN PACIFIC RAILROAD COMPANY, CRAMENTO NORTHERN RAILWAY, TIDE-ATER SOUTHERN RAILWAY, DEEP CREEK ILROAD COMPANY, THE WESTERN REALTY MPANY, THE STANDARD REALTY AND DE-LOPMENT COMPANY and DELTA FINANCE ., LTD.,
Defendants-Appellees.

ÆREDITH H. METZGER, HENRY OFFERMAN d J. S. FARLEE & Co., INC.,
Plaintiffs-Intervenors-Appellants,

vs.

ESTERN PACIFIC RAILROAD COMPANY, CRAMENTO NORTHERN RAILWAY, TIDE-TER SOUTHERN RAILWAY, DEEP CREEK ILROAD COMPANY, THE WESTERN REALTY MPANY, THE STANDARD REALTY AND DE-LOPMENT COMPANY and DELTA FINANCE ., LTD.,
Defendants-Appellees.

No. 12506

BRIEF FOR PLAINTIFFS-INTERVENORS-APPELLANTS

'his is an appeal by plaintiffs-intervenors ("inter-eors" hereinafter) from the final judgment herein of United States District Court for the Northern District f California, Southern Division (Goodman, D. J.), dis-ising the action after a trial without jury. A companion

appeal by plaintiff * is likewise before the Court. The Di trict Court's opinion and findings (R. 258, 319) are r ported 85 F. Supp. 868.

Jurisdiction

The District Court's jurisdiction is predicated on dive sity of citizenship and presence of the jurisdictional amou (28 U. S. C. § 1332) The jurisdictional facts are alleged the complaint (R. 6) and admitted in defendants' answe (R. 12, 117-8).**

The appellate jurisdiction of this Court rests on U. S. C. § 1291. The final judgment below, as amende was filed January 13, 1950 (R. 324-5). The notice of app was filed on February 8, 1950 (R. 327), within the ti limited by 28 U. S. C. § 2107.

Position of Intervenors

In the light of the able and learned brief submitted counsel for plaintiff, we would hesitate to burden t Court with an additional memorandum were it not for c tain differences in presentation and analysis which we c sider as important. The differences arise from the hist of the litigation and the peculiar position of the int venors.

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* Plaintiff-appellant Western Pacific Railroad *Corporation* is he referred to as "plaintiff" or the "Corporation".

Defendant-appellee Western Pacific Railroad *Company* is he referred to as "defendant" or the "Company". With respect to period from November 1935 to December 1944, the reference "defendant" will include its reorganization trustees in whose ha during that time, were defendant's assets and affairs.

The other defendants-appellees are present or former subsidia of the defendant Company and have comparatively minor stake the litigation.

** The intervenors' citizenship (R. 124, 156, 158, 176) is im terial to the jurisdiction; *Golconda P. Corp.* v. *Petroleum Co* 46 F. Supp. 23, 25 (D. C., S. D. Cal., 1942).

The intervenors own 25,465 shares of plaintiff's pre-rred stock (R. 1650-2), about 6.7% of all the preferred itstanding (R. 1717). In June, 1946—prior to this tion—the intervenors instituted a stockholders' action i the federal District Court for Southern New York, in hich the claim involved herein (in addition to other aims) was asserted for the first time (R. 337, 706-7, 124). The New York complaint alleged, in short, that aintiff and defendant had interlocking managements; at plaintiff was controlled by defendant's agents; that ese facts created a fiduciary relation between plaintiff ad defendant, requiring defendant to deal fairly with aintiff; and that defendant, in certain tax transactions th plaintiff, had breached its fiduciary duty to plaintiff appropriating all benefits of the transactions to itself d allowing none to plaintiff.

After the legal sufficiency of the New York complaint d been sustained (R. 337), plaintiff's management and orneys (named as defendants in New York) caused intiff to file its original complaint herein on October 1946, complaining of the same tax transactions with endant (R. 5).

Plaintiff, however, failed to allege the managerial inter-k between the parties or the control of plaintiff by de-dant's agents. Accordingly, we moved for leave to in-vene herein on the ground that plaintiff's management dequately represented the rights of plaintiff and its kholders; and this motion was granted on April 7, 7 (R. 122).

ur intervenors' complaint (R. 123) alleged the facts, tted by plaintiff, establishing what we conceive to be all-important fiduciary relation between plaintiff and endant. Plaintiff at first denied these allegations and the intervenors to their proof * (R. 156); later on plain-adopted certain of our allegations, but not those re-

The intervenors accepted this invitation, as demonstrated by the isive depositions (R. 275) which produced the evidence at the

ferring to its own personnel (R. 208); until finally plai
tiff's present counsel, retained on the eve of trial, likewi
proclaimed the existence of the fiduciary relation.

Nonetheless, substantial differences still exist betwe
plaintiff and intervenors in the presentation and analy
of the factual basis and the legal effect of this fiducia
relation. We are therefore impelled to submit this se
rate brief in which, appearing on behalf of stockhold
(not management), we can let the chips fall where they w

Statement of Case

1. Plaintiff's $75,000,000 stock loss.

In 1916 plaintiff, a holding company, acquired all
stock of defendant, an operating railroad company
493). Plaintiff's investment in defendant's stock was m
than $75,000,000 (R. 262).

In 1935 defendant went into bankruptcy reorganizat
(Bankruptcy Act, § 77) in the Court below, its prope
being placed in the hands of two court-appointed trust
(R. 494). In 1939 the Interstate Commerce Commiss
promulgated a plan of reorganization (233 I. C. C. 4
which declared that defendant's stock held by plain
was worthless and not entitled to share in the assets of
reorganized Company (R. 259, 495). Under the plan
secured creditors of defendant were to become its
owners and were to receive all of its stock, when issued

This reorganization plan was approved by the Dist
Court in 1940 (R. 259). Although reversed on app
In re Western Pac. R. Co., 124 F. 2d 136 (C. C. A. 9, 19
the plan was, on March 15, 1943, reinstated and affir
by the Supreme Court and thus became final; *Ecke*
Western Pac. R. Corp., 318 U. S. 448 (1943). In due cou
the plan was confirmed on October 11, 1943 (R. 260);
it was consummated on December 29, 1944 when the
organization trustees returned the assets to defendant

:endant issued its new securities in accordance with the
ın (R. 499, 2000).

l'he results of defendant's reorganization were shatter-
; to plaintiff. Its principal asset, the $75,000,000 invest-
nt in defendant's stock, was totally lost. The loss was
etrievable; for however prosperous defendant might
:ome in the future, plaintiff had no part therein. From
ırch 15, 1943—the date of the Supreme Court's affirm-
:e of the reorganization plan—the economic unity be-
:een plaintiff and defendant was severed; plaintiff and
:endant became and remained complete strangers to
:h other.

:. Plaintiff's tax credit and its use to save defendant's taxes.

Staggering as plaintiff's loss was, it presented one miti-
ing feature: The amount of the loss could be used as
income and excess profits tax deduction. The right to
s tax credit was created by Internal Revenue Code,
3(g)(4),* enacted in 1942, which provided that losses
ulting from the worthlessness of the stock of an affiliate
 to be treated as operating losses (rather than as capital
s as theretofore).

But plaintiff was not allowed to derive any benefit from
 tax credit. Instead, the entire benefit was reaped by
endant. This was accomplished through the mechanics
 consolidated tax returns.

a) Consolidated tax returns may be filed by an affiliated
up of corporations headed by a common parent and
r-connected by at least 95% stock ownership (Internal
enue Code, § 141). In such a consolidated return the
ated group is treated, for tax purposes, as a single
rprise, so that the losses sustained by any one or more
ates are deducted from the profits realized by the other
ates. Only if the group as a whole realizes a net
it is a tax payable thereon.

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*The text of the statutes and regulations cited is set forth in the
endix of this brief.

A consolidated return can be filed only by the pare corporation of the group; and it requires the consent of a affiliates. Treas. Reg. 104, § 23.12(b) and § 23.16(a).

(b) Plaintiff, as stated, owned all of defendant's stoc Although the Supreme Court's decision of March 15, 194 had rendered the stock economically worthless, it was st legally valid because defendant's reorganization was n yet consummated. Plaintiff continued to own the sto until April 30, 1944, on which date plaintiff surrender it to defendant's reorganization committee (R. 260). Th legal stock ownership made it possible for plaintiff to f consolidated tax returns for itself and defendant, coveri the year 1943 and the first four months of 1944 (see *inf* pp. 42-43).

During this period defendant had realized very substa tial profits from its war-time railroad operations. Ord narily defendant would have had to pay a huge tax—mo than $17,000,000—on its profits (R. 262). But there w an alternative to the payment of this tax: If plaintiff fil consolidated tax returns, plaintiff's tax credit arising fro its stock loss could be offset against defendant's profi and no tax would be payable. This possibility existed n only in the year 1943, in which plaintiff's stock loss h occurred; but plaintiff's tax credit could also be "carri back" to 1942 and "carried forward" to 1944 (Intern Revenue Code, § 122(b)).

(c) The opportunities offered by the tax laws we utilized. Under circumstances to be detailed below, d fendant caused plaintiff to file consolidated returns f 1943 and the first four months of 1944.* These retur (Pl. Exs. 4-A, 4-B, 5-A, 5-B) claimed defendant's sto loss as a complete offset to defendant's earnings; hen they reported no tax as due; and defendant paid no ta for these periods (R. 266-7).

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* For brevity, the returns for the first four months of 1944 a hereinafter referred to as the "1944 returns".

Nor was this all. Defendant had paid $4,201,821.54 in xes for 1942 (Pl. Ex. 6; R. 1654-6). But the carry-back plaintiff's stock loss to 1942 would eliminate all of dendant's tax liability for that year. Accordingly, plaintiff ed a claim with the Government for the refund of these ,201,821.54 (Pl. Ex. 6; R. 1654).

Each of these documents—the consolidated returns and e refund claim—were filed after March 15, 1943, the date the economic severance of plaintiff and defendant, mely:

the 1943 returns on July 15, 1944;
the 1942 refund claim on March 9, 1945;
the 1944 returns on June 15, 1945.
(Pl. Exs. 4-A, 4-B, 5-A, 5-B, 6.)

d) The Government did at first dispute the propriety of lucting plaintiff's stock loss, principally on the ground .t the loss had occurred in 1940 and was therefore inadssible as a deduction against 1943 income (R. 267, 1423- Finally, however, in August 1947, the Government conted to a settlement; plaintiff agreed to the rejection of refund claim for 1942, while the Government acquiesced the 1943 and 1944 tax returns showing no tax due (R. -5, 262-3).

he Court below found that, but for the use of consolied returns and the deduction of plaintiff's stock loss, endant would have had to pay more than $21,000,000 in es for the period 1942 to 1944 (R. 261-2, 265). As a ult of the settlement, defendant paid only about)00,000, so that it realized a net tax saving of more 1 $17,000,000 (R. 266-7).

is our contention that, in equity and fairness, at least ibstantial part of this tax saving belonged to plaintiff that defendant should be required to account therefor laintiff. We proceed to state, in brief outline, the cirstances supporting our position.

3. The anomalous nature of defendant's retention of t tax saving and the denial of any tax benefit to plaintiff.

(a) Normally the tax credit arising from a stock loss—such as that sustained by plaintiff—redounds to the bene of the party who suffered the loss. This is as it should since the tax deduction is designed to mitigate the loss.

Normally, this reasonable result obtains also where parent corporation, by filing consolidated returns, deduc its loss from the earnings of a subsidiary. For the t saving of the subsidiary redounds automatically—throu the payment of dividends or through the increased val of the parent's equity in the subsidiary—to the benefit the parent which, in an economic sense, owns the assets the subsidiary. Again this accords with the purpose of t tax law which permits consolidated returns in order give the parent, as the owner of the group, the benefit all group losses, both its own and its subsidiaries'.

But this normal and intended result of the operati of the tax laws (more fully discussed *infra*, pp. 38 et se completely failed in the case at bar. At the time the c solidated returns here were filed, plaintiff's stockholdi in defendant had been declared worthless by the Supre Court; the economic relationship between plaintiff a defendant had been severed; and plaintiff derived no be fit whatever from any tax savings flowing to defend The purpose of the tax laws was thus perverted: prosperous defendant obtained a wholly gratuitous ded tion for a loss which it had never suffered; while intended automatic upstream flow of defendant's tax s ing to its parent, the plaintiff, was prevented by economic severance of the parties. Plaintiff's stock l remained unalleviated by any tax advantage; while fendant obtained an undeserved and unmotivated tax wi fall.

(b) Plaintiff nevertheless had the means to cause tax benefits to go where, in justice and by the spirit of tax law, they belonged, namely, to plaintiff. For plai

d, as a matter of law, a free choice whether or not it
uld file consolidated returns (R. 1458).* Before filing
nsolidated returns plaintiff's management could have
ide suitable arrangements with defendant concerning the
imate disposition of the resulting tax savings—a type
arrangement both legal and by no means unusual (*infra*,
. 49 et seq.). If defendant was willing to do equity it
s bound to agree that the tax benefits flowing from plain-
f's $75,000,000 loss should belong to plaintiff in order to
tigate that loss. If defendant insisted on its pound of
sh, plaintiff could have at least made sure that it would
eive an appropriate portion of the tax savings. Under
circumstances was defendant in a position to demand
it all the tax savings be given to it and that plaintiff get
thing.

And yet this is precisely what was done. Although virtu-
y all of the tax savings were, by the intent of the tax law
d by every instinct of reason and equity, intended to
tigate plaintiff's loss; and although none of the savings
uld have been accomplished without plaintiff's filing con-
idated returns and the use of plaintiff's tax credit;
vertheless plaintiff was not allowed to receive one cent.
fendant was permitted to retain for itself the entire
,000,000.

. Duality of management.

This complete and abject surrender of plaintiff's interest
defendant has a simple explanation: The allegiance of
intiff's management to defendant. In short, during the
ical period in which the consolidated returns were filed,
intiff's officers were actually subordinate employees of
endant; a majority of plaintiff's board of directors were

* Under Internal Revenue Code, § 141(a), the filing of consoli-
d returns is a "privilege" the exercise of which is optional. The
that plaintiff had filed consolidated returns in earlier years, did
prevent it from filing separate returns for 1943 and 1944; 2 *Mont-
ery's Federal Taxes, Corporations and Partnerships* (1946-47),
650.

employees of defendant; plaintiff's lawyers were simultane ously lawyers for defendant. All compensation paid t these persons was paid solely by defendant, not one cer by plaintiff. These were the people who were charge with the responsibility of protecting plaintiff's interest in its relation to defendant.

The duality of allegiance of plaintiff's management forn an important basis of our claim; it created the fiducia relation and defendant's duty to deal fairly with plainti The facts must therefore be stated in somewhat mo detail.

(a) *Plaintiff's financial collapse and its dependence c defendant.* The Supreme Court's affirmance of defen ant's reorganization plan on March 15, 1943 left plaintiff an empty corporate shell. It had no assets; it had n income; it had no funds (Pl. Ex. 47; R. 573, 790). I principal investment, the stock of defendant, was declar worthless. At the same time, its only other substanti asset, a one-half interest in the stock of the Denver Ra road, was eliminated by the latter's reorganization pl (R. 575).* As one of plaintiff's directors put it, plainti had become a "corporation without assets", a mere "no entity" (R. 1130-1).

From the early days of their affiliation, plaintiff and d fendant had maintained a joint office in New York, staff by common employees (R. 643). On June 1, 1943, on t heels of the Supreme Court's decision, defendant assum the whole expense of the New York office and took ov plaintiff's officers as "full time employees" of defenda (Pl. Ex. 30, R. 527, 1738). The individuals thus taken ov by defendant nevertheless remained the officers of pla tiff, but received their compensation solely from defen ant, nothing from plaintiff (Pl. Ex. 23, R. 520, 1721;

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* The Denver's reorganization plan, approved by the I. C. C order of June 14, 1943 (254 I. C. C. 349, 385), was subsequer affirmed by the Supreme Court, *Reconstruction Finance Corp. Denver and R. G. W. R. Co.,* 328 U. S. 495 (1946).

x. 27, R. 523, 1729-33). On April 30, 1945, at defendant's irection, the New York office was closed (R. 650) and laintiff's officers and records were quartered at the offices f Whitman Ransom Coulson and Goetz, defendant's New 'ork tax counsel (R. 651-2, 655).

Plaintiff's financial collapse, as will be seen, was the gnal for its officers, directors and lawyers to desert the nking ship and to climb on that of defendant. Even aintiff's dominant stockholder, finding its economic stake defendant much larger than that in plaintiff, likewise vitched its allegiance to defendant.

(b) *Plaintiff's stockholders (the James Interests).* In 25, one Arthur Curtiss James, through his personal holdg companies,* acquired 61% of plaintiff's common and 3% of its preferred stock (R. 501), constituting control. y 1943 plaintiff's common stock, ranging behind more an $38,000,000 of preferred (R. 1717), had become cometely worthless; and even the preferred stock was of fling value.

But the James Interests also held large amounts of the cured obligations of defendant (R. 1718) which, under reorganization plan, entitled them to 28% of the to-beued stock of defendant (Pl. Ex. 1).** It was therefore the advantage of the James Interests to favor defendt, not plaintiff. Thus if the tax savings here involved ured to defendant, the James interest therein was 28%; ile it was only 8.8% if the tax savings went to plaintiff. The James Interests acted in accordance with their adntage: They abandoned plaintiff and cast their lot

Arthur Curtiss James died in 1941 (R. 745). He, his estate, his sonal holding companies (R. 503) and the James Foundation of w York, Inc. (R. 1011) are herein referred to as the "James erests".

* Under the plan, the James Interests were entitled directly to ½% of the defendant's new voting stock (R. 975) and, in addi-, to convertible bonds of defendant which the James Interests sequently converted into voting stock of defendant (R. 1718; see 1725-8), giving them an aggregate of 28%.

with defendant. They decided to support defendant's re organization plan (R. 618) which theretofore they had opposed (R. 536-7). They decided to withhold further ad vances to plaintiff (R. 575-6); the James representative on plaintiff's board retired (R. 1480); and at plaintiff's annual meetings the James stock was neither represented nor voted (Pl. Ex. 19, R. 503; Def. Ex. 54, R. 1630, 2053 2069). Plaintiff was thus deprived of that measure of protection and supervision which a vigilant controlling stockholder ordinarily would exercise over a corporation's management.

Plaintiff's 4700 public stockholders (R. 659), scattered throughout the country (R. 659), were forced into equal inactivity since plaintiff was too impoverished even to send out proxies or proxy statements for its annual meetings (Def. Ex. 54, R. 2053-2069). None of those meetings was therefore attended by a quorum (Pl. Ex. 19).

The protection of plaintiff's interests was thus left entirely to the integrity and vigilance of its officers and directors.

(c) *Plaintiff's officers.* During the period in which the consolidated tax returns and the refund claim were filed—1944 and 1945—plaintiff had only two officers: Its president Curry and its secretary Wienken, later replaced by Valouch (R. 1719).

Michael J. Curry was not only the president, treasurer and a director of plaintiff throughout the critical period (R. 1719, 1720) but, at the same time, also a vice-president, a director and a member of the executive committee of defendant (R. 719, 1724).* Despite these titles, Curry considered himself merely a "figurehead" (R. 646-7). His actual position was, and had been since 1927, simply that of chief clerk or office manager (R. 639); he was "merely

* Curry resigned as defendant's vice-president on April 30, 19[illegible] (R. 1724) and as defendant's director on November 20, 1944 (R. 719).

ning officer" (R. 641, 1450) and signed whatever docu- nts Schumacher (defendant's chairman) or Elsey (de- ıdant's president) told him to sign (R. 642). From ne 1, 1943 Curry's entire compensation was paid by de- ıdant (R. 1738); nothing whatever by plaintiff (R. 645). After the closing of the New York office on April 30, 45, defendant arranged for Curry to move to the offices Whitman Ransom Coulson and Goetz, defendant's tax ınsel (R. 1287-8), and for them to pay him a $3,000 an- al "retainer", because Curry's services "as president of old holding company" (i.e., plaintiff) were "essential" connection with the pending tax questions which your npany [i.e., defendant] has up with the Federal Gov- ıment" (Pl. Ex. 32-A, R. 1744). Defendant agreed to mburse Whitman Ransom for these retainer payments s one of our disbursements in connection with the pend- ; tax matters" (R. 1746, 1288). Thus *defendant* paid ırry in order that, as *plaintiff's* president, he might help *fendant* in its tax matters. Defendant also paid Curry small pension (R. 653). Curry remained with the Whit- ın Ransom firm until the latter part of 1948 (R. 656).

During the time when Curry should have safeguarded intiff's interest against encroachments by defendant, he s thus an officer and director of defendant and his live- ood depended solely on defendant.

ohn F. Wienken was plaintiff's only other officer, to wit, secretary; and he remained such until May 1, 1945 (R. 9). He was also a director of plaintiff until April 25, 6 (R. 1720). Although adorned with these weighty es, Wienken was actually a stenographer (R. 648) em- yed by both plaintiff and defendant in the joint New rk office. Since June 1, 1943, his $2,875 annual salary s paid solely by defendant (R. 1735, 1738).

lary C. Valouch became the secretary and a director of intiff on May 1, 1945, upon Wienken's resignation and closing of the New York office (R. 1719, 1720). For

many years before that date, Valouch had been a clerk in the employ of defendant (R. 530); she handled the Western Pacific tax matters and did secretarial work (R. 647). Since June 1, 1943 she received her salary—less than $3,000 annually—solely from defendant (R. 1735, 1738). Upon the closing of the New York office and her appointment as secretary and a director of plaintiff, she moved—together with Curry—to the Whitman Ransom firm and became its employee (R. 530, 652).

Each of the three officers of plaintiff—Curry as president, and Wienken, succeeded by Valouch, as Secretary—was thus during the critical period in the employ and pay of defendant and subject to the inevitable tug of loyalty to his paymaster. By the very nature of their employment they were nothing but dummies and figureheads.

(d) *Plaintiff's directors.* Nine persons were, during all or part of the critical period from 1944 to 1945, directors of plaintiff: Curry, Wienken, Valouch (from May 1, 1945), Schumacher, Sheehan (from February 15, 1944), Hatton Osborn, Wood and Campbell (until May 1, 1945) (Pl. Ex. 22, R. 1720).

Three of these—Curry Wienken and Valouch—have been discussed and their financial dependence on defendant shown.

Thomas M. Schumacher was the real "boss" of the New York office before and during the critical period (R. 639 736). Since 1927 he had been the chief executive officer and a director of both plaintiff and defendant (R. 735) and in 1935 the bankruptcy court appointed him as one of the two reorganization trustees of defendant (R. 735). On February 1, 1942—before the critical period of the consolidated returns here involved—Schumacher resigned as plaintiff's president because of plaintiff's inability to pay his $15,000 salary (R. 743). Nevertheless, in his capacity as compensated trustee for defendant (R. 738-9), Schumacher continued "in command of the New York office

(R. 736) until December 31, 1944, when defendant emerged from the reorganization and Schumacher retired (R. 1724) with a $12,000 pension from defendant (Pl. Ex. 34-C). Although no longer an officer of plaintiff, Schumacher continued as a member of its board of directors until his death n early 1948. Throughout the critical period Schumacher was paid only by defendant, not by plaintiff (R. 645).

Catherine Sheehan was the telephone operator, recepionist and filing clerk in the joint New York office (R. 647, 138). Her $2,000 salary was paid solely by defendant R. 1138-9, 1738). She was elected to plaintiff's board n order to fill a quorum (R. 1139), never took part in the iscussions of the board and, in casting her vote, simply ollowed the majority (R. 1140).

William W. Hatton was a minor officer of the Denver ailroad (R. 1134), charged with "purely clerical" duties t a salary of $4,500 (R. 1137). Schumacher was his superior and chief" (R. 1135). Hatton—like Sheehan—as elected to plaintiff's board in order to fill a quorum R. 1137-8); he never participated in board discussions and mply voted with the majority (R. 1136).

A. Perry Osborn was not only a director of plaintiff nce 1937 (R. 988), but also a director and member of the ecutive committee of defendant to November 20, 1944 R. 992).

Willis D. Wood was a long time friend of Arthur Curtiss ames, at whose request he had joined plaintiff's board R. 1123). During the period 1943-45, Wood and his family wned substantial amounts of defendant's securities (Int. Ex. 11, R. 2138-2141), but none of plaintiff's, except qualiing shares (Pl. Ex. 17, R. 1717). Since the Supreme ourt's decision of March 15, 1943, he considered plaintiff a "non-entity", so that "there was no action necessary on y part, and hence I did not give it the attention that I d in former years" (R. 1130-1).

H. Brua Campbell, an attorney, was a partner of the New York law firm of Pierce & Greer (R. 532-3), which, as will presently be stated more fully, were attorneys for both plaintiff and defendant during the critical period 1944 and 1945, but received their compensation solely from defendant, nothing from plaintiff.

A clear majority of plaintiff's directors—Curry, Wienken, Valouch, Schumacher, Sheehan, Osborn and Campbell—thus owed their allegiance to defendant. All of those just named (except Osborn) received their pay solely from defendant, nothing from plaintiff. And even the two remaining directors (Wood and Hatton) were likewise by interest and allegiance oriented to defendant.

(e) *Plaintiff's lawyers.* Two New York law firms acted for plaintiff during the critical period:* Its general counsel, Pierce & Greer; and the firm of Whitman Ransom Coulson and Goetz, as tax lawyers.

Pierce & Greer. This firm, composed of *H. Brua Campbell* and *Frank C. Nicodemus* (R. 532-3), acted not only as general counsel for plaintiff (R. 533), but simultaneously as attorneys for defendant and its trustees (R. 533-6, 793). Their representation of defendant continued throughout 1945 (R. 1119-21, 2150). Since June 1, 1943 they received no compensation from plaintiff (R. 1723). They did receive an annual retainer from defendant's trustees and additional fees from defendant (R. 534-8, 1730-1, 1738).

Defendant and its bankruptcy trustees never made any bones about their conception of the duties of the Pierce & Greer firm in tax matters: They looked to the firm "to cooperate with Mr. Matthew, general counsel for the Trustees [of *defendant*], in protecting the trust estate [i.e. *defendant*] in the preparation of the final return" (Pl. Ex. 39-A, R. 543-4).

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* A California attorney, Judge Marcus C. Sloss, was retained by plaintiff in 1934 solely to represent its interests as a stockholder and unsecured creditor in the reorganization proceedings of defendant by opposing the I. C. C.'s plan of reorganization (R. 1603, 1611). He had nothing to do with plaintiff's taxes (R. 1603-4).

Much later, on October 10, 1946 (simultaneously with the ·ommencement of this action), Nicodemus became a director of plaintiff.

Whitman Ransom Coulson and Goetz. In March 1943 this firm was retained as tax counsel for the Western Pacific group, including both plaintiff and defendant (Pl. Exs. 39-A to 39-E, R. 543-547; R. 556). The firm continued as tax counsel for plaintiff until at least 1947 (R. 1438-41); and they are still tax counsel for defendant (R. 1438). The partners in charge of the tax work were *Robert E. Coulson* and *James K. Polk* (R. 1399).

The firm's compensation for its tax work was paid ex-·lusively by defendant (R. 548-557); nothing was paid by plaintiff (R. 1721). But the firm was tied to defendant by ·ven more profound considerations.

For nearly twenty years the firm had been personal coun-el to Arthur Curtiss James and general counsel to the arious corporations created by him (R. 536, 962); Coulson ·as an officer and director of these corporations (R. 964). ·s attorney for the A. C. James Company, Coulson took n active part in all steps of defendant's reorganization R. 963); in 1943 he became a member of defendant's re-rganization committee which was charged with effectuat-ıg and consummating the reorganization plan (Pl. Ex. 10, . 1674, 1677); and in December 1944 he became a director f defendant (R. 548). By reason of their large financial ake in defendant, the James Interests, represented by oulson's firm, were vitally interested in defendant's wel-ıre, including its taxes (R. 965); while, since the Supreme ourt's decision of March 15, 1943, their interest in plain-ff was negligible; so that, as we have shown, the James ıterests cast their lot with defendant and abandoned aintiff (*supra*, pp. 11-12).

It is therefore understandable—although hardly excus-ıble—that Polk, while attorney for both plaintiff and de-ndant, thought "my responsibility was to them [defend-ıt] and not to the corporation [plaintiff]" (R. 1431).

This distorted view of a lawyer's duty to his client accorded with Coulson's ante-litem expression that his firm was dealing with the tax matters "in behalf of The Western Pacific Railroad Company [i.e, defendant]" (R. 529) and that plaintiff was "without financial stake" in the consolidated returns (R. 1744). Indeed, even after this action and the New York stockholders' suit had notified Coulson of plaintiff's "financial stake", he persisted in taking sides with one client, defendant, against the other client, plaintiff. For on December 11, 1946—while he and his firm were still actively representing plaintiff in the tax matte (R. 1438-41)—Coulson assured counsel for defendant tha his interest was "solely in protecting the operating company" [i.e., defendant] in connection with this and the New York litigation (Int. Ex. 9, R. 2133-4).

To summarize: Plaintiff's entire personnel—its dominant stockholders, its officers, its directors and its lawyer —was infected with dual allegiance which prompted then in any conflict of interest between plaintiff and defendan to give their first and foremost loyalty to defendant. W proceed to show how the conduct of these persons in handling the tax transactions was actually influenced by thei divided loyalties.

5. Duality in action in the handling of the consolidate returns.

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Important as these questions were, plaintiff was not pe mitted to pose, let alone to answer them. Without

much as asking plaintiff, *defendant* made the decision that plaintiff was to file consolidated returns and make its tax credit available to defendant (R. 1448-1450, 1278). Plaintiff's role was confined to the mechanical, unquestioning and uninformed execution of defendant's decision.

(a) *The returns for 1943.* The thought of utilizing plaintiff's stock loss as a tax deduction in consolidated returns was first suggested in Polk's letter of May 20, 1943, addressed to *defendant* (Pl. Ex. 50, R. 1757, 1760-1). The letter did not mention that plaintiff might have to be consulted.

By December 1943, Coulson and Polk were prepared to recommend definitely the adoption of Polk's suggestion (R. 1409-10). They made their recommendation—but only to *defendant.* Early in January, 1944, Polk traveled to the west coast where defendant's principal office was located, and there advised the trustees and officers of *defendant* that the use of plaintiff's stock loss in a consolidated return would eliminate all 1943 taxes (R. 1267-8, 1410-11, 1448). Defendant, although quite unconcerned about plaintiff's concurrence in the plan, was concerned about the legal soundness of Polk's advice and therefore requested a formal opinion of the Whitman Ransom firm (R. 1268, 1411). On January 11, 1944 Coulson sent this opinion from New York to *defendant* (Pl. Ex. 54, R. 605)—with not even a copy to plaintiff (R. 665). The opinion assumed, as a matter of course, that plaintiff would join in consolidated returns and would bestow upon defendant the tax benefits flowing from plaintiff's stock loss.

Defendant was satisfied with this opinion. Without bothering to ask for plaintiff's permission, defendant simply decided * to use plaintiff's tax credit to eliminate its own taxes (R. 1448). Defendant at once acted pursuant to this decision. It reversed, in January, 1944, tax accruals of about $7,500,000 theretofore placed on its books

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for 1943 (R. 873, 1770). In March 1944 it advised the bankruptcy court that no taxes would be payable for 1943 (Pl. Ex. 58, R. 1772). And in May, 1944—still before the 1943 returns were filed—defendant stated in its report to stockholders that plaintiff "can and will" file consolidated returns in which plaintiff's stock loss "will result in elimination" of defendant's tax liability (Pl. Ex. 20-B, R. 512).

Who, then, decided on behalf of plaintiff that it "will" file such consolidated returns? Its board of directors did not; the 1943 tax matters were never presented to plaintiff's board, either for discussion or decision (R. 1018). Nor did its then two officers, its president Curry, and its secretary Wienken. The latter had nothing at all to do with taxes; and Curry was a mere "figurehead", a "signing officer", and completely ignorant of tax matters ("tax matters were wholly Greek to me. I didn't understand them at all * * * ", R. 808).

The method by which defendant caused plaintiff to file the consolidated returns for 1943 was simple. After *defendant* had resolved that plaintiff would file the consolidated returns utilizing its stock loss (R. 1448, 1278), such returns were prepared by Valouch (then a full time employee of *defendant,* but neither an officer or director of plaintiff), under the supervision of Polk (R. 663). The completed returns were given by Valouch to Curry for his signature (R. 664). At Curry's question, Valouch assured him that Polk had approved the returns (R. 664). Thereupon Curry, without questioning Polk or his firm as to why plaintiff should endow defendant with the stupendous gift of this tax saving; without his asking or even thinking whether it would not be fair for plaintiff to receive the tax savings or at least a part thereof, as an offset against its huge loss; without giving any thought to the wisdom of retaining independent counsel to ascertain and protect plaintiff's rights against defendant; and without bothering to consult plaintiff's directors—Mr. Curry, the "signing officer", did just that: He signed (R. 664).

(b) *The returns for 1944 and the refund claim for 1942.* The story for the 1944 returns is much the same as for the preceding year. Plaintiff's board was not consulted; it never considered or decided on the filing of consolidated returns (R. 1018). What happened was that on December 20, 1944 Coulson advised *defendant*—but not plaintiff—by telegram that "the only course open is to proceed as indicated in conversations with you, including report on the consolidated basis up to May 1 [1944]" (Pl. Ex. 62, R. 623). Thereupon the decision to file consolidated returns for the first four months of 1944 was made by *defendant*—not by plaintiff (R. 1449-50). The returns were then prepared in Polk's office and brought to Curry for his signature (R. 666). At that time Curry had moved to the Whitman Ransom suite with instructions from Coulson to "put himself at Polk's disposal" (R. 1498); and this meant that, under his retainer, he, as plaintiff's president, was to perform such services, as defendant would require to achieve and safeguard the tax savings for itself. Hence when Curry was told that Polk wanted him to sign the returns, he obliged—again without asking plaintiff's board of directors (R. 666).

The refund claim for 1942 was prepared with even less ceremony than the tax returns. Polk himself decided that plaintiff should file such a claim (R. 1450). He prepared the claim; placed it before "the proper signing officer", i.e., Curry, with the request for his signature (R. 1450); and Curry signed, again, of course, without benefit of consultation or approval by plaintiff's board of directors (R. 666-7).

That Curry, in signing, was preoccupied with defendant's interests, not plaintiff's, is indisputably established by his own contemporaneous statements. Plaintiff was confronted in February, 1945, with a possible forfeiture of its charter for non-payment of Delaware franchise taxes. Curry, in discussing the problem, gave serious consideration to it—but only with an eye to defendant's tax savings and their possible jeopardy; and without any thought to

the interests of plaintiff and its stockholders. This is clearly stated in a letter from Curry, as plaintiff's president, to Nicodemus, copy to Polk (Int. Ex. 5, R. 2125-7):

> "If we default and our charter is voided, the question arises what would be the effect on the consolidated income and excess-profits tax returns filed by the Corporation, as parent, for the years 1942, 1943 and 1944. As you know, a very large deduction was taken in 1943, which wiped out any tax liability for that year and will also have an effect upon the 1942 and 1944 consolidated returns. I understand the total tax saving to The Western Pacific Railroad Company [i.e., defendant] will amount to about 15 million dollars. Therefore, I feel the payment or non-payment of these franchise taxes must be determined particularly from the Federal income tax angle.
>
> "I would suggest that before arriving at a decision in this matter you confer with the firm of Whitman, Ransom, Coulson & Goetz, our tax counsel, who are aware of this situation and are considering the consequences which the non-payment of these franchise taxes would have from an income tax viewpoint."

The same thought had long before been expressed by Coulson and Polk.* Coulson therefore decided that plaintiff's franchise tax must be paid; and the A. C. James Company—departing in this instance from its policy of making no further advances to plaintiff (R. 575-6)—loaned plaintiff the funds to pay its franchise tax (R. 713).

(c) *The tax settlement with the Government.* The proceedings culminating in the 1947 settlement of the tax dispute with the Government further illustrate the extent to which defendant managed plaintiff's tax affairs with complete disregard of plaintiff.

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* On May 26, 1943, Polk advised Nicodemus that plaintiff's "dissolution should be deferred * * * as tax aspects warranted" (R. 601). On June 26, 1943, Coulson asked Polk whether "it would be embarrassing in the Western Pacific situation" if plaintiff's charter were cancelled for failure to pay its Delaware franchise tax; Polk replied "it is essential, to protect the possible use of the net loss carry-back, that the holding company [i.e., plaintiff] continue until the consummation of the reorganization" (R. 592).

In 1945 and the early part of 1946, an Internal Revenue agent audited the tax returns for 1942-1944 (R. 1419). For his discussions with the Government Polk needed a power of attorney from plaintiff (R. 1424). Polk drafted such an instrument (Pl. Ex. 65, R. 1784). Among other things it authorized Polk and two of his partners to "execute closing agreements", i.e., to settle any tax dispute. At Polk's request, Curry, then lodged in Coulson's office, signed this power of attorney—again, of course, without consulting plaintiff's board and without the board's knowledge or approval (R. 667-8, 1025-6). Significantly, Curry felt that the signing of the power of attorney was one of his duties under his retainer agreement with the Whitman Ransom firm (R. 906) under which the latter paid him $3,000 annually, for the account of defendant.

Armed with this power of attorney, Polk entered upon his discussions with the Government (R. 1424-5). At a conference in Washington on February 11, 1947 Polk suggested the possibility of a settlement (R. 1427-8). When the Government representative asked Palk to put his offer in writing, Polk replied that he would get authorization to do so (R. 1427). Polk promptly proceeded to procure such authorization—but only from *defendant*, not from plaintiff (R. 1429-31). He immediately telephoned Coulson, who at the time was in San Francisco, and outlined to him the proposed offer (R. 1429-30). Coulson at once consulted *defendant's* president Elsey, who, in turn, canvassed *defendant's* directors (R. 1282-4). After a few hours Elsey advised Polk by telephone that his proposed settlement offer was approved by *defendant* (R. 1430). Polk at once reduced his offer to writing and, in *plaintiff's* name, submitted it to the Government (R. 171, 1430). The thought that plaintiff might have to be consulted occurred, they say, to no one (R. 1431). Until two months later plaintiff's directors and officers had no information whatever of what was being done in their names (R. 668-9).

This patent disregard of plaintiff's rights was also manifested in the terms of Polk's settlement offer. At the

time the offer was made (February 11, 1947), the present action was already pending and defendants had filed their answers asserting certain technical defenses, such as the statute of limitations (R. 28-29). But these technical defenses would obviously have been unavailable as to any moneys which might come directly into plaintiff's possession and as to which, therefore, plaintiff would not have to sue defendant. The 1942 tax savings were of that character. The refund claim for 1942 (R. 1654) was, and had to be, filed by plaintiff; if the claim had been allowed by the Government, the $4,201,821.54 taxes for 1942 would have been paid by the Government to plaintiff.* The refund claim was therefore particularly valuable to plaintiff since the 1942 tax moneys, if collected by plaintiff from the Government, were not subject to defendant's technical defenses. Polk's settlement proposal provided that plaintiff was to surrender its refund claim for 1942, whereas defendant was to be freed of any tax liability for 1943 and the first four months of 1944 (R. 171-3). The proposed settlement was thus to be accomplished wholly at plaintiff's expense.

Not until two months later, after a conference with defendant on April 2, 1947, did it occur to Polk to notify plaintiff of the settlement offer which he had made in its name, and to request the approval of plaintiff's board (Pl. Ex. 68, R. 1788, 1460-1). The board members, alerted by our New York shareholders' action to their possible personal liability, appointed a three-man committee to consider the settlement offer. On May 5, 1947 Curry, on behalf of the Committee, notified Polk that they were "prepared to recommend" to plaintiff's board the sending to Polk of a "letter of general approval", but demanded a stipulation by defendant which would assure to plaintiff its day in court, free of the technical defenses asserted in

* Treas. Reg. 104, § 23.16(a), provides that, with respect to consolidated returns, the Government deals only with the parent corporation of an affiliated group, and that refunds will be made directly to the parent.

defendant's answers (Pl. Ex. 69, R. 1794). In effect, this letter instructed Polk not to proceed with the settlement until such a stipulation between plaintiff and defendant were made.

These instructions from his client and principal made no impression on Polk. Without waiting for the stipulation or for plaintiff's "letter of general approval", without, indeed, further asking or even notifying plaintiff (R. 681, 1027-8), Polk, on May 19, 1947, again acting as plaintiff's attorney in fact, renewed his settlement offer to the Government in the identical terms of his previous offer (Pl. Ex. 71, R. 1799). On August 13, 1947 the Government accepted Polk's offer (R. 174, 1437). The settlement thus became an accomplished fact, without ever having received advance approval by plaintiff.

(d) *Stipulation and pre-trial order concerning the effect of the tax settlement.* Promptly upon learning of the settlement in August, 1947, the intervenors moved the Court below for an order restraining its consummation (R. 163). In the face of this application, and after hearings before the District Court on August 25 and 26, 1947 (R. 164), plaintiff and defendant entered into a stipulation dated September 3, 1947 (Pl. Ex. 7, R. 1658), approved and strengthened by a pre-trial order of the District Court (R. 163, 166), to the effect that this litigation shall be decided as though plaintiff's $4,201,821.54 refund claim for 1942 had been allowed and paid by the Government, but diminished in the proportion in which the total tax savings were diminished by the settlement. In other words: The settlement with the Government reduced the total tax savings from $21,000,000 to $17,000,000, i.e., by 4/21. As between the parties, the $4,261,821.54 refund claim shall be deemed reduced by 4/21 thereof, i.e., to $3,401,474.58. The litigation shall be decided as though this $3,401,474.58 had been paid by the Government to plaintiff and had been deposited by plaintiff in Court.

The importance to this litigation of the pre-trial order and stipulation is considerable, as will be shown.

(e) *Defendant's $10,100,000 reserve for this litigation.* At the time the consolidated returns herein were filed in 1944 and 1945 defendant anticipated a tax controversy with the Government and therefore created a $10,100,000 tax reserve, which it invested in United States Treasury Savings Notes (R. 616-7).

After the tax settlement with the Government in 1947, defendant continued this $10,100,000 tax reserve as a reserve against the outcome of this litigation (R. 517-8, 617).

Specification of Errors Relied Upon

1. The District Court held that the Government was improperly deprived of taxes due it and that the injustice to the Government cannot be cured by committing the further inequity of distributing the gain thus made to others.

This holding, we contend, was error.

2. The District Court held that the allowance of plaintiff's claim would permit it to share in the earnings realized by defendant during its reorganization, contrary to the decree confirming defendant's reorganization plan (R. 274-5).

This holding, we contend, was error.

3. The District Court held—or at least intimated—that there was "some merit to defendant's contention that a firm obligation rested upon plaintiff" to join defendant in the filing of consolidated tax returns (R. 275).

We contend that this holding, if it was intended as such, was error.

Summary of Argument

We propose to show:

1. Defendant was obligated to deal fairly with plaintiff because of the duality of management (Point I).

2. Fairness required defendant to allow plaintiff all or at least a substantial part of the tax savings (Point II).

3. The grounds upon which the District Court dismissed the action were erroneous (Point III).

POINT I

Defendant was obligated to deal fairly with plaintiff because of the duality of management.

The parties, engaging in the tax transactions we have described, did not deal at arm's length. That was prevented by the duality of their personnel and the dominant role of defendant in the tax transaction. We contend that, acting in this position, defendant was required by law to treat plaintiff with the highest degree of fairness; that defendant's duties to plaintiff were those of a fiduciary to his *cestui;* and that the dealings between the parties are subject to close and jealous judicial scrutiny.

Under this pointhead we shall demonstrate the existence and scope of defendant's duties; under the next, their violation by defendant.

1. The duality rule.

(a) Throughout the critical period during which the consolidated returns and the refund claim were filed (July 15, 1944 to June 15, 1945), the management of plaintiff was shot through with divided allegiance to defendant. The

rule is deeply imbedded in our law that the existence of interlocking managements between two corporations will create a fiduciary relation between them.

Geddes v. *Anaconda Copper Mining Co.,* 254 U. S. 590, 599 (1921), contains the classical and most frequently cited formulation of the doctrine:

> "The relation of directors to corporations is of such a fiduciary nature that transactions between boards having common members are regarded as jealously by the law as are personal dealings between a director and his corporation; and where the fairness of such transactions is challenged, the burden is upon those who would maintain them to show their entire fairness; * * * This court has been consistently emphatic in the application of this rule, which, it has declared, is founded in soundest morality and, we now add, in the soundest business policy. Twin-Lick Oil Co. v. Marbury, 91 U. S. 587, 588; Thomas v. Brownville, Ft. K. & P. R. Co., 109 U. S. 522; Wardwell v. Union P. R. Co., 103 U. S. 651, 658; Corsicana Nat. Bank v. Johnson, 251 U. S. 68."

The rule is of universal application. It has been recognized by this Court, *Geddes* v. *Anaconda Copper Mining Co.,* 245 Fed. 225, 235-6 (C. C. A. 9, 1917), rev'd on other grounds 254 U. S. 590, in holding

> "that upon principle contracts between corporations having a common director should be regarded very much as are contracts between individual directors and their corporations, and that while such contracts are not prohibited, and are not prima facie void or fraudulent, they are voidable, and that the burden rests upon those who seek to sustain them to show clearly and satisfactorily that they are entirely fair and free from wrong."

The law is the same in Delaware, where plaintiff is organized; in California, where defendant is incorporated; in New York, where plaintiff's officers functioned and the returns were filed; and in other jurisdictions throughout the land.

Keenan v. *Eshleman,* 23 Del. Ch. 234, 243-4, 2 Atl. 2d 904 (S. Ct., 1938);

Kennedy v. *Emerald Coal & Coke Co.,* 42 Atl. 2d 398, 402 (S. Ct., Del., 1944);

Goodell v. *Verdugo Canon Water Co.,* 138 Cal. 308, 71 Pac. 354 (1903);

Title Ins. & Tr. Co. v. *California Development Co.,* 171 Cal. 173, 205-6, 152 Pac. 542 (1915);

Chelrob v. *Barrett,* 293 N. Y. 442, 460-2, 57 N. E. 2d 825 (1944);

Globe Woolen Co. v. *Utica G. & E. Co.,* 224 N. Y. 483, 489-90, 121 N. E. 378 (1918, Cardozo, J.);

Mayflower Hotel Stockholders Protective Committee v. *Mayflower Hotel Corp.,* 173 F. 2d 416, 418-423 (App. D. C., 1949, with numerous references).

The rule rests on wisdom, as old as Holy Writ, that "no man can faithfully serve two masters, whose interests are or may be in conflict"; *San Diego* v. *San Diego & L. A. R. Co.,* 44 Cal. 106, 113 (1872). Just as there is danger that a director, in dealing with his corporation, will favor his personal interests, so in transactions between interlocking corporations "the danger to be avoided is that a director or group of directors, common to two corporations, may, for reasons of self-interest, favor one of the entities in its dealings with the other"; *Mayflower Hotel* case, *supra,* 173 F. 2d, at 420. Hence, courts impose "the most careful scrutiny of transactions between the corporations represented by common directors, to the end that in the absence of arm's length bargaining, the scales may not, even through mistake or inadvertence, be unfairly tipped to one side or the other"; *Chelrob* v. *Barrett, supra,* 293 N. Y., at 461.

Hence we contend that the mere fact of the duality of the parties' personnel subjected defendant, in its dealings with plaintiff, to the strict duty to treat plaintiff with the highest degree of fairness and loyalty.

(b) But even beyond the mere duality, defendant's duty was here further strengthened by the dominant role which it assumed in the tax transactions. We need not repeat that the decision to use plaintiff's tax credit for the elimination of defendant's taxes was made by defendant, not by plaintiff; that plaintiff's board was never consulted; and that Curry, who signed the returns and the refund claim, while nominally president of plaintiff, was actually but a clerk and office manager, a full-time employee of defendant, in the exclusive pay of defendant, acting at the behest of defendant conveyed to him by tax counsel for defendant.

One who, like defendant, takes such dominant part in the affairs of another becomes his fiduciary. Thus a stockholder, not ordinarily a fiduciary of his corporation, is treated as such in any transaction in which he dominates the corporation's conduct; *Pepper* v. *Litton,* 308 U. S. 295, 306 (1939); *Kavanaugh* v. *Kavanaugh Knitting Co.,* 226 N. Y. 185, 194-5, 123 N. E. 148 (1919). A non-stockholder wielding such influence, no matter by what means, is subject to the same duties. "It is the fact of control * * *, not the particular means by which or manner in which the control is exercised, that creates the fiduciary obligation"; *Southern Pacific Co.* v. *Bogert,* 250 U. S. 483, 492 (1919, Brandeis, J.).

Thus in *Title Insurance & Trust Co.* v. *California Development Co.,* 171 Cal. 173, 152 Pac. 542 (1915), the Southern Pacific Company held no stock in the Development Company, but had made large loans to it, reserving the right to appoint three of the latter's seven directors. This was held to have placed the Southern Pacific Company "in a position of effective domination" over the Development Company (171 Cal., at 205). The Court went on:

> "Having such control and dominion * * *, the Southern Pacific Company occupied a fiduciary relation toward the California Development Company and its stockholders and creditors. * * * The Southern Pacific Company, by thus taking control of the directorate and the business of the development company, ren-

dered itself subject, at least, to the restrictions which are imposed upon a director of a corporation." (171 Cal., at 206)

The present defendant's domination of plaintiff in their tax transactions was no less. It follows inevitably that defendant owed plaintiff the strictest duties of a fiduciary.

2. Scope of the duality rule.

Defendant does not deny that the parties operated under interlocking managements; nor does it question the duality rule as such. To escape its consequences, defendant argues for certain exceptions which, it says, should here be grafted upon the ancient fiduciary standards—in defiance of the "uncompromising rigidity [which] has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions", *Meinhard* v. *Salmon*, 249 N. Y. 458, 464, 164 N. E. 545 (1928, Cardozo, J.).

We shall briefly discuss defendant's claimed exceptions.

(a) *Good faith.* Defendant says that the dual personnel was honest and free from evil motive. But judicial scrutiny of the fairness of a transaction between interlocking corporations will not be forestalled by a showing that the common officers acted honestly and in good faith.

> *Chelrob* v. *Barrett, supra,* 293 N. Y., at 460-2;
> *Overfield* v. *Pennroad Corp.,* 42 F. Supp. 586, 610 (D. C., E. D. Pa., 1941), rev'd on other grounds 146 F. 2d 889;
> *Blum* v. *Fleishhacker,* 21 F. Supp. 527, 533 (D. C., N. D. Cal., 1937), mod. and aff'd 109 F. 2d 543, cert. den. 311 U. S. 665;
> *Bernheim* v. *Louisville Property Co.,* 185 Ky. 63, 73, 214 S. W. 801 (1919).

In each of these cases the courts paid tribute to the good faith and honesty of the dual actors as well as to their independence and freedom from domination; they simultaneously imposed the fiduciary duty to deal fairly and found its breach.

Indeed, the rule could not be otherwise. Duality works in an insidious fashion. Even if it does not corrupt the honesty of the dual agent, it may insensibly dampen the exertion of his best skill and ingenuity. Thus defendant here asserts that dual tax counsel never had any thought of plaintiff's right to the tax savings (R. 1433, 1473-5). Assuming these protestations, they merely emphasize the deadly effect of divided allegiance. For the evidence shows that tax counsel had at hand all the information which might lead him to the realization of plaintiff's rights.* His failure to realize them may well have been due to a lack of wholehearted devotion to plaintiff's cause. To say whether it was or not, would involve that "calculus of probabilities [which] is beyond the science of the chancery", *Meinhard* v. *Salmon, supra,* 249 N. Y., at 465. Hence the rigid rule of prophylaxis which, in the presence of duality, requires absolute fairness, regardless of subjective honesty and good faith.

(b) *Absence of secrecy.* Defendant denies any attempt to conceal the tax transaction from plaintiff. But dealings between interlocking companies, unless found altogether fair, will not be saved by the absence of secrecy. As held in *Blum* v. *Fleishhacker, supra,* 21 F. Supp., at 533, "the question of secrecy is immaterial. * * * the publicity alone of an illegal or unauthorized act of the directors of a

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* As we shall later show, the problem of an inter-company adjustment of tax savings was not uncommon. It arose, just during the critical period, under the S.E.C.'s Rule U-45(b)(6) and was treated in several S.E.C. decisions. In 1943, Polk was familiar with Rule U-45(b)(6) and referred to it in giving advice concerning the tax allocation of the Western Pacific group (R. 1466-7). Copies of the S.E.C. decisions, discussed below, were received by Polk's firm at the time they were released between June, 1943 and January, 1945 (R. 1467-8).

corporation does not make it legal or valid". Accord: *Goodell v. Verdugo Canon Water Co., supra,* 138 Cal., at 314.

Moreover, as to the alleged absence of secrecy it might be noted that defendant was quite reluctant to disclose its use of plaintiff's tax credit. It will be recalled that, when defendant resolved to pay no taxes for 1943, it simultaneously decided to create a tax reserve; but this reserve was to be hidden under the unrevealing designation "Reserve for Road Improvements" (Pl. Ex. 53, R. 1770; Int. Ex. Ident. 19, R. 2155-6). This camouflage proved unfeasible; but defendant nevertheless issued a directive to its officers to withhold all information regarding the source of its tax saving (Int. Exs. Ident. 18-B and 18-C, R. 2152-4). The first public disclosure was defendant's 1943 report to *its* stockholders (Pl. Ex. 20-B) which, although dated May, 1944, was not released until July, 1944 (R. 1278)—too late for any independent stockholder of plaintiff to take action before the 1943 tax returns were filed on July 15, 1944.

(c) *Origin of duality.* Defendant says that plaintiff cannot invoke the duality rule because plaintiff itself created the duality. The argument assumes that plaintiff appointed defendant's officers and directors and therefore cannot complain of their identity with its own management. Actually, however, plaintiff had, during the critical period, no say in the selection of defendant's management. During defendant's reorganization, its trustees, directors and officers were appointed by the bankruptcy court. And after defendant emerged from reorganization in December, 1944, its management was selected by its new stockholders, not by plaintiff.

In any event, it is immaterial who created the duality. There is nothing invidious about interlocking managements as such. Indeed, "business convenience many times requires interlocking directorates"; 3 *Fletcher Cyc. Corp.* (Perm. Ed., 1947) § 961, p. 433. But once duality is created—no matter by whom or how innocently—it subjects the entities

to fiduciary standards in their dealings with each other; *In re James Estate,* 86 N. Y. S. 2d 78 (Surr. Ct., 1948). Even though a parent corporation, for business convenience, has created duality, nevertheless it is held protected from unfair treatment in transactions with its own subsidiary. *Potter* v. *Sanitary Co. of America,* 22 Del. Ch. 110, 194 Atl. 87 (1937); *Banco Kentucky Co.'s Receiver* v. *National Bank of Kentucky's Receiver,* 281 Ky. 784, 137 S. W. 2d 357 (1939).

(d) *Officers of the court.* During defendant's reorganization, its affairs were managed by two court-appointed bankruptcy trustees; and defendant's dual employees were, technically, the employees of the trustees. Defendant asserts that the normal duty of the court to review transactions consummated by dual actors does not apply where the dual actors are, or work for, trustees appointed by the court. This is said to be so because a court-appointed trustee has no personal ax to grind; no self-interest; no concern except to be just and objective.

This contention is novel; it is contrary to common sense; and it is contrary to the authorities. Defendant in effect argues that the unfairness found by the courts in the *Chelrob, Pennroad* and *Bernheim* cases, *supra,* would have been beyond the power of the court to redress if the dual management had been appointed or employed by a court trustee. We believe that the strict supervision exercised by a court over its officers argues for the opposite conclusion.

In *Koral* v. *Savory, Inc.,* 276 N. Y. 215, 11 N. E. 2d 883 (1937), a stockholder brought a derivative action on behalf of a corporation whose affairs were in the hands of a court-appointed receiver. A demand by the plaintiff that the receiver bring the suit had been refused. The defendants demanded dismissal of the action as an improper interference with the discretion exercised by the receiver. But the court sustained the complaint (276 N. Y., at 220):

"Here the complaint alleges facts which, if true, show that the refusal is not due to an 'unprejudiced exercise of judgment,' but on the contrary that the receiver is a clerk in the office of the attorneys for the defendants and that his primary interest is to prevent the corporation from redressing the wrongs committed by the clients of his employer."

The court thus unhesitatingly applied the rule of duality to an officer appointed by the court; and the same course has been adopted whenever the question arose. *In re Los Angeles Lumber Products Co.*, 46 F. Supp. 77, 88 (D. C., S. D. Cal., 1941); *In re James Estate, supra,* 86 N. Y. S. 2d 78; *Brinckerhoff* v. *Bostwick*, 88 N. Y. 52, 60 (1882).

3. Application of the fiduciary rule to tax transactions.

Fiduciaries who mishandle a company's tax affairs or derive private tax advantages from their management of the company's tax business, are subject to the same accountability as in other transactions with their *cestuis*.

Commercial National Bank in Shreveport v. *Parsons,* 144 F. 2d 231, 236-7 (C. C. A. 5, 1944), reh. den. 145 F. 2d 191, cert. den. 323 U. S. 796;
Leslie v. *Commercial National Bank in Shreveport,* 28 F. Supp. 927, 933 (D. C., W. D. La., 1939);
Commercial National Bank in Shreveport v. *Connolly,* 176 F. 2d 1004 (C. C. A. 5, 1949), reh. den. 177 F. 2d 514;
Truncale v. *Universal Pictures Co.,* 76 F. Supp. 465 (D. C., S. D. N. Y., 1948);
Mahler v. *Oishei* (N. Y. Co. Index No. 28485, N. Y. Sup. Ct., Nov. 12, 1947), reviewed 61 Harvard L. Rev. 1058 (1948).

Thus, in the *Shreveport Bank* cases, *supra,* the "old bank" had transferred certain real estate to the "new bank" as collateral security for claims of the new bank. Under the applicable tax laws of Louisiana, a corporation owning real estate was entitled to certain tax deductions.

The new bank, as the technical legal owner of the aforesaid real estate, claimed and procured such tax savings. But the courts held that the real estate belonged equitably to the old bank; that the new bank was the fiduciary of the old; and that it must, therefore, account for all private tax savings which it procured in the conduct of its fiduciary activities:

> "The dominant officers of the new bank were the directors of the old, and they were doubly bound to treat the latter fairly." (144 F. 2d, at 236)
>
> "There can be little question but that the relation of the new Bank to the old and the administration of the property and estate intrusted to the former, was one requiring the utmost good faith and constituted it an agent, trustee or fiduciary. * * * It could not profit therefrom in any manner * * *.
>
> " * * * the new Bank * * * should not be allowed to take credit for the taxes paid under the circumstances of this case." (28 F. Supp., at 933)

In the *Truncale* case, *supra* (76 F. Supp. 465), the directors of a corporation had exercised options to buy the corporation's stock at prices far below its market value. The difference between the market value and the purchase price constituted taxable income to the directors and, at the same time, a tax-deductible expense to the corporation. The directors, in violation of their fiduciary duties, caused the corporation to waive its right to this tax deduction; the corporation's waiver enabled the directors to save substantial amounts of their private taxes. The directors were held accountable to the corporation for their tax savings, although the amount of their savings far exceeded the tax detriment which the corporation had sustained by reason of its waiver.

The present case likewise involved a tax transaction between plaintiff and defendant. Plaintiff and defendant had to agree to join in the consolidated returns, plaintiff by electing to file them, defendant by giving its consent. By

filing the returns, plaintiff made the tax credit arising from its stock loss available to reduce defendant's taxes; plaintiff surrendered thereby, *pro tanto,* its privilege to use its tax credit as a reduction of its own future taxes. Moreover, by filing the returns, plaintiff subjected itself to joint and several liability for any taxes or tax deficiencies which the Government might assess on defendant's income (Treas. Reg. 104, § 23.15(d)). In short, by joining in consolidated returns, the parties engaged in a transaction which profoundly affected their mutual rights and relations.

We submit that, in the light of the duality of plaintiff's management and the dominant part which defendant played in the tax transactions, defendant was under the fiduciary obligation to treat plaintiff with the highest degree of fairness in these tax transactions. We proceed to show that defendant breached this obligation.

POINT II

Fairness required defendant to allow plaintiff all or at least a substantial part of the tax savings.

Fairness, whatever its other connotations, demanded that defendant refrain from taking "undue advantage" of plaintiff.* The filing of the consolidated returns here conferred great advantage—a $17,000,000 tax saving—on defendant, the fiduciary. It conferred no advantage on plaintiff, the cestui. The transaction was thus unilaterally advantageous to the fiduciary. This, we contend, was an "undue advantage" to defendant. Fairness required defendant to make an agreement allowing plaintiff a substantial share in the benefits procured by their joint action.

A more detailed analysis will support our contention.

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* *Sheehan* v. *Erbe*, 77 App. Div. 176, 79 N. Y. S. 43, 45 (1st Dept., 1902).

A

The purpose of the tax law was to benefit plaintiff.

The fairness of a transaction allocating tax benefits between two private parties will in considerable measure depend upon the purpose of the tax law which creates the benefit. Thus if the enjoyment of the $17,000,000 tax saving by defendant, and the denial of any share therein to plaintiff, accorded with the purpose and philosophy of the tax law, then there is much to be said for the fairness of the transaction as between the parties. If, however, defendant's enjoyment of the tax saving was a mere windfall to it, made possible by the letter of the tax statute, but unsupported by its underlying purpose; and if plaintiff's enjoyment of those savings would more nearly fulfill the statutory purpose; then an agreement allowing plaintiff all or a substantial share would indeed be fair.

A brief discussion of the applicable tax laws and their purpose is therefore necessary.

1. *The purpose of § 23(g)(4) of the Internal Revenue Code.*

Prior to 1938 a loss resulting from the worthlessness of stock held by a taxpayer was fully deductible for tax purposes. In 1938 the Code was amended to make such losses "capital losses", deductible only from capital gains. In 1942, however, § 23(g)(4) was added to the Code, providing that a loss sustained through the worthlessness of the stock of an affiliate constitutes an ordinary loss, unrestrictedly available as a tax deduction from any kind of income (R. 267-8).

Defendant's stock held by plaintiff became worthless in 1943; and under § 23(g)(4), plaintiff could use this stock loss as a tax deduction.

As stated by the Court below (R. 268), the legislative history of § 23(g)(4) throws no light upon its purpose and philosophy. That purpose, however, would seem to be

self-evident: The new section was designed to mitigate the economic impact of such a stock loss. Accordingly the authorities, more fully discussed below, recognize that, realistically, the tax saving resulting from a stock loss should be viewed as a partial offset to such loss; *Matter of Consolidated Electric & Gas Co.*, 15 S. E. C. 161, 164 (1943).

Since in this case the loss was sustained by plaintiff, the tax credit arising therefrom was likewise designed for plaintiff, in order to offset its loss.

Plaintiff's management failed to take any step to effectuate this purpose. Its sole interest was to make plaintiff's tax credit available to defendant. This objective was accomplished through the filing of consolidated tax returns, with the result that plaintiff's tax credit was not used to mitigate plaintiff's loss but to confer upon defendant what the Court below called an "amazing and undeserved" tax benefit (R. 276).

This diversion of the tax credit from plaintiff to defendant was not only contrary to the purpose of § 23(g)(4); it was also, as we now proceed to show, contrary to the purpose of consolidated returns.

2. *The purpose and mechanics of consolidated returns.*

(a) Consolidated tax returns are permitted by § 141 of the Internal Revenue Code and are governed by regulations issued by the Commissioner of Internal Revenue. These returns may be filed by an "affiliated group of corporations" interconnected by at least 95% stock ownership. The privilege of filing consolidated returns is designed for the protection and benefit of the common owner, or parent, of the affiliated group. Without consolidated returns, the investor, that is, the parent company, investing in two subsidiaries, one profitable, and the other a losing proposition, would have to pay a tax on the income from its good investment, without being able to deduct its loss from the bad one. The rationale of consolidated returns

> "is the recognition of this common owner's right to set off against his gains in the one [corporation] his losses in the other [corporation]";

Duke Power Co. v. *Commissioner,* 44 F. 2d 543, 545 (C. C. A. 4, 1930), cert. den. 283 U. S. 903.

The underlying principle has been well stated by the Court below (R. 269):

> "* * * the philosophy of the consolidated return is to disregard the corporate entity and to tax as a single business or economic unit what really is a business unit * * *. It treats an affiliated group of corporations as one business enterprise, the various affiliates being considered as if they were branch offices of the main business establishment. The income from all units is considered as a single income and the losses of all units are treated as a single loss. (Citing authorities)."

The same thought is clearly expressed in the *Report of the Senate Finance Committee*, 70th Cong., 1st Sess., S. R. 960, p. 14 (1928), quoted in *Spreckels Co.* v. *Commissioner,* 41 B. T. A. 370, 375 (1940):

> "The permission to file consolidated returns by affiliated corporations merely recognizes the business entity as distinguished from the legal corporate entity of the business enterprise. * * * The mere fact that by legal fiction several corporations owned by the same stockholders are separate entities should not obscure the fact that they are in reality one and the same business owned by the same individuals and operated as a unit. To refuse to recognize this situation and to require for tax purposes the breaking up of a single business into its constituent parts is just as unreasonable as to require a single corporation to report separately for tax purposes the gains from its sales department, from its manufacturing activities, from its investments, and from each and every one of its agencies."

Accord:

Handy & Harman v. *Burnet*, 284 U. S. 136, 140 (1931);

Atlantic City Electric Co. v. *Commissioner*, 288 U. S. 152, 154 (1933);

Alameda Investment Co. v. *McLaughlin*, 28 F. 2d 81, 82 (D. C., N. D. Cal., 1928), aff'd 33 F. 2d 120 (C. C. A. 9, 1929).

Consolidated returns are thus permitted for the benefit of the "common owner" of the affiliated enterprise, that is, the parent corporation. They are not permitted for the benefit of the subsidiaries. If a subsidiary operates profitably it has no ground, in its own person, to seek a reduction of its taxes, even though its parent, or another subsidiary of the parent, has sustained a loss; for such loss cannot affect the financial position of the profitable subsidiary. But otherwise the common parent; in an economic sense, the profits of each member of the group are the profits of the parent, and the losses of each member of the group are the losses of the parent; the right to offset such losses and profits against each other is therefore the parent's right, created in the interest and for the benefit of the parent. As stated in the *Alameda* case, *supra* (28 F. 2d, at 82), "The benefit of the statute extends to him on whom is the hazard of the several enterprises", that is, the parent.

It is true that consolidated returns may also redound to the advantage of the subsidiary. Thus where a losing parent files a consolidated return for itself and a profitable subsidiary, the latter's taxes may be reduced. But this tax advantage is not allowed for the subsidiary's sake. It is allowed for the parent's sake which, normally, gets the full benefit of the subsidiary's tax savings by the automatic operation of economic factors—either through the increased value of the parent's stock in the subsidiary or through the declaration of dividends.

(b) In the present case, however, this intended benefit to the parent through the automatic upstream flow of the subsidiary's tax savings to the parent was stopped entirely. For the Supreme Court's decision of March 15, 1943 had destroyed plaintiff's equity in defendant, so that plaintiff, although under the tax law the intended beneficiary of its subsidiary's tax saving, received no benefit whatever. Instead, defendant, the profit-making subsidiary, reaped the entire benefit of a loss it had never suffered.

(c) How was this anomalous result possible under the tax law? The answer lies in the history and phraseology of the consolidated return statute.

Originally consolidated returns were regulated in strict accordance with their underlying purpose: They could be filed only by a group of affiliated corporations actually constituting an economic unit. See *United States* v. *Cleveland, P. & E. R. Co.,* 42 F. 2d 433 (C. C. A. 6, 1930), setting forth the early history of consolidated return law. In such an economic unit the automatic upstream flow of a subsidiary's tax saving to the parent was necessarily assured. But the statutory definitions of economic unity proved so vague as to be unworkable, leading to confusion and extensive litigation. In the interest of administrative convenience the test of affiliation was therefore simplified: The legal ownership by one corporation of at least 95% of the stock of another corporation was made the sole test of affiliation (Internal Revenue Code, § 141(a)). Once this requirement is met, consolidated returns may be filed even though, in exceptional cases, there is no economic unity so that the purpose of consolidated returns is not achieved.*

The present is such an exceptional case. Indeed, defendant itself and its tax counsel recognized its "unusual" and "paradoxical" character (R. 512, 1760). The economic

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* *Burnet* v. *Aluminum Goods Mfg. Co.,* 287 U. S. 544 (1932); *George A. Fuller Co.* v. *Commissioner,* 92 F. 2d 72 (C. C. A. 2, 1937); *Trinity Buildings Corp.* v. *Commissioner,* 40 B. T. A. 1315 (1939).

unity between plaintiff and defendant was severed by the Supreme Court's approval of defendant's reorganization plan on March 15, 1943. But plaintiff still continued to own all of defendant's stock; for defendant's reorganization plan was not yet consummated; and until consummation, defendant's stock held by plaintiff was legally valid. This stock ownership, although economically a fiction, provided the legal affiliation sufficient for the filing of consolidated returns.

(d) While these tax transactions were thus proper so far as the Government was concerned, it does not follow that the results were fair as between the parties. In determining their fairness, equity is concerned with realities rather than fictions. The fact is unshakable that defendant realized a $17,000,000 tax saving, not because of a loss of its own, but because of a loss of plaintiff. The fact is unshakable that the consolidated returns, although properly filed, failed to achieve the statutory purpose of benefiting plaintiff, the parent of the affiliated group. And the fact is unshakable that the tax credit arising from plaintiff's stock loss was designed to mitigate that loss, not to confer a huge and undeserved advantage on defendant. In short, all reasons of statutory purpose, economic logic and common fairness point to plaintiff as the intended beneficiary of these tax savings. Not a single reason justifies their retention by defendant. In defendant's hands, these tax savings are a windfall, without economic rhyme or reason—a perversion of the purposes of the tax laws.

Had plaintiff's affairs been in the hands of an unbiased and independent management, intent solely on plaintiff's interest, it might well have rejected so anomalous and unwarranted a result. It was free to refrain from filing consolidated returns; for, under the tax laws, plaintiff's was the choice to file consolidated or separate returns; and if plaintiff, the parent corporation, "decided that its best interests required filing by it of a separate return, no provision of the law denied it this privilege"; *Duke Power*

Co. v. *Commissioner, supra,* 44 F. 2d, at 545. An independent management of plaintiff, with these thoughts in mind, before consenting to consolidated returns and to the use of plaintiff's tax credit by defendant, might well have insisted on an agreement with defendant assuring plaintiff a fair share in the dollars to be achieved by their joint action. And defendant's management, if willing to act fairly, would have acceded to such a demand.

Indeed, as we now proceed to show, agreements of this type are, and were at the time, a familiar device and had repeatedly received administrative sanction.

B

Agreements for the fair allocation of tax savings among affiliated corporations are well supported by precedent.

The question whether the tax benefits arising from consolidated returns have been fairly allocated among affiliated companies will rarely reach the cognizance of a court, since ordinarily the affiliation is too close for inter-company controversies. The question has, however, arisen from time to time in the field of public utility holding companies under regulations issued by the Securities and Exchange Commission. Although these regulations are not directly applicable to the present parties, their administration by the S. E. C. discloses the underlying principles of fairness which sanction the present plaintiff's claim.

The S. E. C. regulation most directly pertinent is the Commission's Rule U-45(b)(6), applicable to affiliated groups of public utility companies, and specifically regulating inter-company tax adjustments. This rule directs, in effect, that ordinarily the consolidated tax payable by an affiliated utility group shall be allocated among the members of the group in the proportion of their respective net incomes, but that deviations from this formula may be permitted by the Commission. As stated by the Commission, "Rule U-45(b)(6) was designed to effect a fair distribu-

tion of taxes based on consolidated returns".* To effectuate this purpose, the Commission has approved deviations from its rule and permitted "tax saving payments", i.e., payments by a profitable affiliate to a losing affiliate for the use of the latter's tax credit. The Commission's rulings and opinions are therefore significant on the issue of fairness herein.

Matter of Consolidated Electric & Gas Co., 15 S. E. C. 161 (1943), involved an affiliated group of utility companies including a parent corporation ("Consolidated") and 44 subsidiaries. Parent and subsidiaries filed consolidated tax returns. The parent had sold the assets of nine of the subsidiaries, sustaining a large loss on its investment therein. This loss could be used as a tax reduction by reason of a 1942 amendment of the Internal Revenue Code —the same amendment which qualified the present plaintiff's stock loss as a tax deduction. If the loss sustained by Consolidated was utilized in the consolidated return, the taxes payable by the affiliated group would be reduced by more than $2,000,000. Most of this tax saving would redound to the benefit of the subsidiaries, only a small fraction to the direct benefit of the parent.

In order to prevent the subsidiaries from receiving this undeserved windfall at the expense of their parent, the group members entered into an agreement under which the subsidiaries were to pay to their parent all of the tax savings resulting from the parent's capital loss. Since this arrangement was intrinsically fair, the Commission approved it:

> "To the extent that tax savings may accrue to the parent in connection with such sales, the result is in effect to reduce the amount of loss accruing to Consolidated by virtue of the transaction." (p. 163)

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* *Matter of Cities Service Company* (S. E. C. Holding Company Act Release No. 5535, January 3, 1945, File No. 70-933); see *infra*, p. 46.

> "Under all the circumstances we believe that it is more realistic to view the tax savings as, in effect, partial offsets to the capital loss otherwise suffered by Consolidated in connection with the sales." (p. 164)

Like considerations should control the case at bar. The present plaintiff, like Consolidated, sustained an extraordinary capital loss giving rise to a tax deduction. The tax deduction here, like that in the *Consolidated* case, was designed as "partial offset to the capital loss". Just as it was fair for Consolidated to collect from its subsidiaries the tax savings which they obtained through Consolidated's loss,* so it would have been fair for plaintiff to obtain a similar arrangement with defendant.

Indeed, the present case is much stronger than *Consolidated*. The Consolidated group—unlike the Western Pacific group—constituted an economic unit. The tax savings of Consolidated's subsidiaries thus enured automatically to the benefit of the parent; and the Commission noted that Consolidated might have secured most of the tax benefits of its subsidiaries through the payment of dividends (15 S. E. C., at 164). The permission for tax saving payments was thus a matter of expediency rather than necessity. By contrast, the economic unity of the Western Pacific group was destroyed. Plaintiff could derive no automatic benefit from the tax saving of defendant; an agreement for the sharing of the tax savings was thus, not merely a matter of expediency, but imperatively required in the interest of fairness, to effectuate the "more realistic" view of the tax savings as partial offsets to plaintiff's capital loss.

Matter of Cities Service Company (S. E. C. Holding Company Act Release No. 5535, January 3, 1945, File No. 70-988) contains an even broader statement of the applicable policies. Cities Service Co. was the parent of

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* The tax savings paid to the parent in *Consolidated* were solely those flowing from the use of Consolidated's stock loss. Other tax savings flowing from the consolidated return remained with the subsidiaries.

an affiliated utility group filing consolidated tax returns; Refining Corporation was a subsidiary. Under the war emergency, the Refining Corporation had built a refinery at a cost of $77,000,000, borrowed in large part from the Reconstruction Finance Corporation. The refinery was subject to rapid obsolescence. Pursuant to special dispensation, Refining Corporation was permitted to amortize its investment, for tax purposes, over a period of five years; in other words, it had in each year a tax deduction equal to 20% of its $77,000,000 investment. If these tax deductions were utilized in consolidated returns, they would enure to the benefit of other affiliates rather than that of Refining Corporation. This would be an undeserved advantage to those affiliates who had not, with borrowed funds, made a large investment threatened with early obsolescence. The affiliates therefore agreed to pay to Refining Corporation their tax savings derived from the latter's amortization tax credits; and the S. E. C. approved. We quote the Commission's conclusions in full:

> "Conclusions
>
> "Rule U-45 (b) (6) was designed to effect a fair distribution of taxes based on consolidated returns. In appraising a proposed deviation from our rule we think it should be observed that in the ordinary case the fact that one subsidiary contributes a particular income deduction to a consolidated return does not in itself entitle that subsidiary to the benefits of the reduced taxes resulting from the deduction. Where tax reductions are possible from filing a consolidated return, they ordinarily are due to a number of factors contributed by the various members of the consolidating group, including, among others, earnings, and excess profits tax credits, as well as income deductions.
>
> "On the basis of the estimates of the tax liability for 1944 it appears that Refining Corporation will contribute special deductions but that the other subsidiaries will contribute the income necessary to permit full utilization of the deductions. Thus, while a portion of the tax reductions possible from consolidation could not be realized without the special amortization

items, the reduction likewise could not be realized in the absence of the income furnished by the other companies.

"Obviously it is difficult to determine the precise weight to be given to these various factors and in this case the problem is made more difficult since we have available the results of only five months' operation of the refinery.

"However, the impact of our rule in this instance and the circumstances surrounding the construction of the refinery as recited above persuade us that we should grant the exception requested if the effect in subsequent years will not cause undue detriment to the other subsidiaries of Cities. We shall therefore permit the declaration to become effective, but in order that we may have an opportunity to examine the future effects of the amended contract and take any action which may appear necessary or appropriate following such examination, our order will be subject to the condition that the proposed amendment to the contract regarding allocation of Federal income and excess profits tax liability shall cease to be effective upon order of the Commission after notice and opportunity for hearing.

"An appropriate order will issue."

This decision clearly shows that the S. E. C. was concerned with the same problem here presented, namely, "a fair distribution of taxes based on consolidated returns." The problem was further similar to ours in that the five-year amortization of the investment was tantamount to an investment loss spread over five years. The S. E. C. held that the tax credit arising from such a loss is designed to mitigate the loss; hence it found fair an agreement among the affiliates effectuating that purpose by a tax saving payment to the Refining Corporation, particularly since the latter needed that payment to discharge its loan obligation to the Reconstruction Finance Corporation. Nor was the arrangement inconsistent with the underlying purpose of the consolidated return statute to benefit the common parent of the group; for the Cities Service group was an

economic unit; hence, whichever affiliate might obtain the tax saving in the first place, it was bound to enure ultimately to the benefit of Cities Service, the common parent; and Cities Service, in its own interest, wished to channel the payment to the Refining Corporation.

In the present case the retention of the tax savings by defendant would defeat not only the purpose of the tax law to alleviate plaintiff's investment loss. It would also defeat the purpose of the consolidated return statute to confer a tax benefit on the parent company. Both purposes would be achieved if plaintiff were permitted a share in defendant's tax savings. We submit that fairness required defendant to make an agreement with plaintiff allowing plaintiff such a share; and since plaintiff's dual management failed to seek or make it, a court of equity will see that equity be done by awarding judgment to plaintiff for its fair share of the tax savings.

C

Defendant's arguments disputing the propriety of a tax adjustment between plaintiff and defendant are unsound.

In the Court below defendant advanced various arguments against our position. We turn to answering those appearing most important.

1. *The alleged illegality of a tax adjustment agreement.*

Defendant contended below that it could not have agreed to pay plaintiff a share of the tax savings; for such an agreement would have been tantamount to a merchandising of tax advantages and would have been illegal.

If the argument were valid, the agreements approved by the S. E. C. in the two last quoted cases and in several others* would have been illegal. Equally illegal would

* *Matter of Consolidated Electric & Gas Co. (The Islands Gas & Electric Co.)*, 13 S. E. C. 649 (1943); *Matter of Ogden Corporation* (S. E. C. Holding Company Act Release No. 5904, July 23, 1945); *Matter of United Public Utility Corporation* (S. E. C. Holding Company Act Release No. 6301, December 31, 1945).

be the Commission's Rule U-45(b)(6) which requires affiliated utility companies to enter into tax adjustment contracts in accordance with the formula prescribed by the Commission. But actually, no provision of law requires that tax savings—unlike any other savings—must remain where they happen to fall, even if they fall in the wrong pocketbook.

The error of defendant's argument is easily demonstrated: Agreements between affiliated corporations for the allocation of tax burdens and tax benefits among themselves are expressly sanctioned by statute and Treasury regulation.

(a) Originally the subject of inter-company tax allocation was covered by the statute itself. § 142(b) of the Internal Revenue Act of 1918 provided that a consolidated tax shall be assessed upon the respective affiliated corporations "in such proportions as may be agreed upon among them".* Allocation agreements made under this provision were binding not only among the parties, but even on the Commissioner who could collect from each affiliated corporation only such share of the consolidated tax as it had agreed to assume.

Since this statutory scheme made the collection of consolidated taxes unduly difficult, it was abandoned by the 1928 amendment of the Revenue Act which authorized the Commissioner of Internal Revenue to make appropriate regulations governing the subject; Internal Revenue Code, § 141(b). Pursuant to this authorization, the Commissioner promulgated Treas. Reg. 104, § 23.15, which provided:

"(a) Several Liability of Members of Affiliated Group.

* "In any case in which a tax is assessed upon the basis of a consolidated return, the total tax shall be computed in the first instance as a unit and shall then be assessed upon the respective affiliated corporations in such proportions as may be agreed upon among them, or in the absence of any such agreement, then on the basis of the net income properly assignable to each. * * *" (§ 142(b) of the Internal Revenue Act of 1918).

"Except as provided in paragraph (b), a common parent corporation and each subsidiary, a member of the affiliated group during any part of a consolidated return period, shall be severally liable for the tax (including any deficiency in respect thereof) computed upon the consolidated net income of the group.

* * * * * *

"(d) Effect of Inter-company Agreements.

"Any agreement entered into by one or more members of the affiliated group with any other members of such group or with any other person shall in no case have the effect of reducing the liability prescribed under this section."

This regulation thus had a threefold effect: It made each group member severally liable to the Government for the entire tax; this liability to the Government could not be impaired by an inter-company agreement; but as between the members of the group the validity of inter-company agreements for the allocation of tax burdens or tax benefits was recognized. Unquestionably, therefore, an agreement between plaintiff and defendant, allowing plaintiff a share in the tax savings of defendant, would have been legal.

(b) The so-called "merchandising of tax advantages"—condemned in cases such as *Gregory* v. *Helvering,* 273 U. S. 465 (1935), and *Higgins* v. *Smith,* 308 U. S. 473 (1940), more recently also by Internal Revenue Code, § 129—relates to altogether different situations. They involve attempts of taxpayers to escape their normal tax liability to the Government by distorting their transactions through the artificial interposition of a newly organized or acquired corporation. By contrast, the tax adjustment agreement which, we say, should have been made between plaintiff and defendant would not have been designed to escape an otherwise existing tax liability. The agreement would have been effective only as between the parties; it would not have been designed to affect the Government's right to assess any taxes due it; and it would not have involved the artificial distortion of an otherwise taxable transaction.

The doctrine forbidding the merchandising of tax advantages is, therefore, beside the point.

(c) Defendant contends that tax saving payments, even though not illegal, have met with administrative condemnation. But there, too, the fact situation was quite different from that at bar.

Defendant relies on a report of the Federal Trade Commission * which was rendered before the enactment of the Public Utility Holding Company Act of 1935 (15 U. S. C. §§ 79 et seq.). The report relates that it was a not uncommon practice for public utility holding companies to pay taxes for their groups on a consolidated return basis, while collecting from their operating subsidiaries contributions in amounts equal to the taxes which each subsidiary would have had to pay on a separate basis; the difference was retained by the parent. The result was to increase the operating expenses of the subsidiaries; and, in consequence, the public was charged higher rates for electricity and gas. The practice was criticized on this ground by the F. T. C., which recommended, in the interest of the "protection of the rate-paying public", an amendment of the tax laws prohibiting such arrangements (Report, pp. 69-70). Plainly, the Commission's criticism is inapplicable to non-utility companies such as the present parties; and it has nothing to do with extraordinary fact situations such as that at bar, where the economic unity of parent and subsidiary has been destroyed, so that the intended automatic upstream flow of the tax savings to the parent is prevented.

The F. T. C.'s recommendation was not adopted by Congress. Instead, Congress enacted the Public Utility Holding Company Act which left the subject matter for regulation by the Securities and Exchange Commission. The S. E. C., in turn, adopted its Rule U-45(b)(6); and under

* Federal Trade Commission, Summary Report to the Senate of the United States, pursuant to Senate Resolution No. 83, 70th Cong., 1st Sess., on Economic, Financial and Corporate Phases of Holding and Operating Companies of Electric and Gas Utilities, Part 72-A, Sen. Doc. No. 92, 70th Cong., 1st Sess.

this rule, as we have seen, the Commission repeatedly allowed tax saving payments in the interest of fairness because of the presence of extraordinary circumstances similar to those at bar.

We submit that, in the circumstances here present, an agreement by defendant to allow plaintiff a fair share of its tax savings would have been altogether legal; and that no grounds of public policy would have opposed such an agreement.

2. *Absence of detriment to plaintiff.*

Another argument of defendant urges that defendant's use of plaintiff's tax credit caused plaintiff no injury. For in none of the years involved did plaintiff have taxable income against which it could have offset its tax credit; hence plaintiff suffered no detriment through the use of its tax credit by defendant.

This argument is crowded with fallacies.

(a) To begin with, it does not meet the issue in this case. The issue here is whether it was fair for defendant to retain all the tax savings or whether in fairness it should have allowed plaintiff a share therein. Since by the very purpose of the tax laws the tax savings were designed for the benefit of plaintiff, plaintiff should have been given at least a fair share; and the denial of that share to plaintiff constituted plaintiff's detriment.

To illustrate: Suppose that a fiduciary manages two businesses, one belonging to himself, the other to his cestui. By combining the purchasing power of the two, he buys merchandise at prices cheaper than each business would have had to pay separately. Manifestly it would be unfair for the fiduciary to keep the whole price saving for himself. The cestui is entitled to a fair share of the saving; and this right cannot be defeated by the argument that the cestui is not damaged because, buying separately, he could not have achieved the saving.

Fairness or unfairness are thus the test of recovery herein; detriment to plaintiff is inherent in any finding that it was treated unfairly.

(b) In any event, detriment or injury to plaintiff is no prerequisite to recovery by plaintiff. For defendant, in its dealings with plaintiff, was subject to the duties of a fiduciary; and, under elementary rules, a fiduciary deriving profit from a transaction conducted by him as such is accountable to the cestui for the profit, although the cestui has suffered no loss or injury.

The basic rule is set forth in the *Restatement of Restitution* (1937), § 1, Comment e, pp. 14-15:

> "So, also, where a person in a fiduciary relation to another makes a profit in connection with transactions conducted by him as fiduciary, he is ordinarily accountable to his beneficiary for the profit, although the beneficiary suffered no loss (see Restatement of Agency, § 388, and Restatement of Trusts, § 203)."

Indeed, it must be so; for the fiduciary rule

> "is not based on harm done to the beneficiary in the particular case, but rests on a broad principle of preventing a conflict of opposing interests in the minds of fiduciaries, whose duty it is to act solely for the benefit of their beneficiaries."
>
> *Restatement of Restitution,* § 197, Comment c, pp. 809-810.

This Court, in *Fleishhacker* v. *Blum,* 109 F. 2d 543, 546 (C. C. A. 9, 1940), cert. den. 311 U. S. 665, recognized the same rule by holding a bank officer accountable for the breach of his fiduciary duty,

> "even though the bank has suffered no damage (Restatement, Restitution, § 197, Comment c)."

Direct authorities on the point are the *Shreveport Bank* cases (*supra*, p. 35). There, it will be recalled, the "new bank" had derived tax savings from the fact that it was the technical legal owner of certain real estate which equitably belonged to the "old bank". The new bank's procurement of these tax savings caused no detriment whatever to the old. Nevertheless, the courts held that the new bank, as a fiduciary of the old, must account to the latter for its tax savings:

> "There can be little question but what the relation of the new Bank to the old * * * was one requiring the utmost good faith and constituted it an agent, trustee or fiduciary. * * * It could not profit therefrom in any manner other than as provided by the contract, * * *. If the transaction involved in this case had been between individuals, or if the stock could have been taxed directly to the [new] Bank, and he or it had used the value of the property standing in his or its name for personal profit by having the taxes reduced, he or it would have been bound to account to the principal for such profit regardless of whether the principal had suffered injury or not. 3 C. J. S., Agency, § 165, page 54."
>
> (28 F. Supp., at 933)

Just as the defendant in the *Shreveport Bank* cases was held accountable for its tax saving, even though it had caused no loss or detriment to the plaintiff, so, in the case at bar, the alleged absence of injury to plaintiff does not relieve defendant from allowing plaintiff at least a fair share of the tax savings secured by the use of plaintiff's tax credit.

(c) We have assumed so far that defendant's use of plaintiff's tax credit caused plaintiff no injury. But even that premise of defendant's argument cannot stand.

Whether or not plaintiff's tax credit was a thing of value must be determined as of the time defendant appropriated

it. The first appropriation occurred on July 15, 1944, the date on which the consolidated returns for 1943 were filed. At that time it was still possible that plaintiff might have taxable income of its own in the latter part of 1944 and 1945; and plaintiff's tax credit could be carried forward to offset any such taxable income. While it is true that the possibility of future income did not materialize, that is hindsight and irrelevant. Plaintiff's tax credit, when appropriated by defendant, was a thing of value; its diversion necessarily injured plaintiff.

A second reason likewise demonstrates the value of plaintiff's tax credit. Even if plaintiff could not use it, defendant could. The very fact that plaintiff's tax credit was useful to defendant made it a valuable asset.

Defendant's argument that plaintiff's tax credit was worthless because plaintiff had no direct use for it, is tantamount to saying that, if I own the right shoe of a pair and you own the left, I may appropriate your shoe and you will not be injured; because, forsooth, the left shoe alone was useless to you. Such reasoning would hardly be persuasive.

The present case is comparable. Defendant could not save its taxes without using plaintiff's tax credit. Plaintiff, in turn, could not have utilized its tax credit except by offsetting it against defendant's income. Both defendant's taxable income and plaintiff's tax credit were necessary elements to achieve the tax saving, just as both the right shoe and the left shoe were necessary to make a useful garment. The only difference is that plaintiff's tax credit here was created for the very purpose of conferring a tax saving on plaintiff in order to mitigate its stock loss; not to confer an undeserved and unmotivated tax advantage on defendant; so that it might well be argued that plaintiff is entitled to a greater share of the tax savings than defendant.

A close analogy to this aspect of our case is furnished by *Truncale* v. *Universal Pictures Co., supra* (76 F. Supp. 465). As previously stated, a corporation there was caused

by its directors to waive its right to a certain tax deduction; this enabled the directors to save their private taxes in an amount substantially exceeding the corporation's tax detriment. The question arose whether the corporation could recover only the amount of its tax detriment or, on top of that, the tax savings of the directors. The court decided for the latter alternative; for

> "where a corporation has the freedom to do an act or to refrain, the doing of the act, enabling others to derive benefits in excess of the loss suffered by the corporation, has a 'sale' value of which the ceiling is the amount of such benefits * * *" (76 F. Supp., at 469).

By the same token the present plaintiff had the freedom to make its tax credit available to defendant or to refrain from doing so. Hence, the "doing of the act", i. e., making the tax credit available to defendant, had a "sale value" of which the ceiling was the amount of defendant's benefit, i. e., defendant's tax saving.

3. *An attempted reductio ad absurdum of our position.*

Defendant has depicted horrible consequences which would follow from the allowance of our claim. If plaintiff be entitled to share in defendant's tax savings, then, according to defendant, every corporation making its tax credit available to an affiliate would have the same right. Every consolidated tax return filed by an affiliated group of corporations would give rise to innumerable controversies between the "loss companies" and the "income companies".

Defendant's apprehensions are unfounded. A recovery by plaintiff under the unique facts of this case would have none of the far-reaching implications projected by defendant.

(a) The unique or, as defendant put it (R. 512), "unusual" character of this case grows from the combination

of two factors: The cataclysmic nature of plaintiff's loss; and the filing of consolidated returns by corporations nominally affiliated, but actually total strangers. Each of these factors gives rise to equities in plaintiff's favor. Plaintiff's loss cried for mitigation; the tax laws were designed to give it; but the total economic severance of the parties prevented it. Plaintiff's case derives its strength from this extraordinary congery of events, each unusual by itself.

(b) No comparable equities exist under normal circumstances. Normally consolidated returns are filed by an affiliated group constituting an economic unit, owned by a "common owner"; this, indeed, is the "presumption on which the right [to file consolidated returns] is made to rest" (*Duke Power* case, *supra,* 44 F. 2d, at 545). The economic unity may not be complete; the rights of creditors or minority stockholders of a subsidiary may dilute it; still, by and large, the parent will be the ultimate owner of the assets of each subsidiary, will suffer from its losses and will automatically benefit from its tax savings.

In such a unified group, there will be little basis to support claims for tax saving payments. Thus if the parent company of the group sustains a loss and one of its subsidiaries is profitable, the subsidiary's tax saving automatically benefits the parent (by enhancing the value of the parent's stock in the subsidiary); the purpose of the tax laws is thereby achieved; and with that purpose achieved, there will, as a rule, be no ground in equity to compel a tax saving payment.

Conversely, if the parent has a profit and one of its subsidiaries a loss, a tax saving payment by the parent to the subsidiary would be contrary to the purpose of the consolidated return statute; for that statute is designed for the parent's benefit, not the subsidiary's.

It follows that in the ordinary situation of an affiliated group constituting an economic unit there will hardly, if ever, exist any basis for tax saving claims. As stated by

the S. E. C. in *Matter of Cities Service Company* (*supra*, p. 47):

> " * * * in the ordinary case the fact that one subsidiary contributes a particular income deduction to a consolidated return does not in itself entitle that subsidiary to the benefits of the reduced taxes resulting from the deduction."

The allowance of plaintiff's claim, based upon the extraordinary facts at bar, would therefore not mean the allowance of similar claims in the absence of such extraordinary circumstances. Defendant's pretended concern that the decision herein will furnish a rule applicable to all affiliated groups filing consolidated returns is misplaced.

We submit that, in the circumstances of this case, nothing in the tax laws justifies the retention by defendant of its undeserved tax savings; and that fairness and the purpose of the tax laws required defendant to allow plaintiff at least a substantial share of the tax benefits derived from plaintiff's tax credit. And since defendant, as a fiduciary, was required to deal fairly with plaintiff, equity should direct defendant to do now what it should have done long ago, namely, to pay at least a substantial part of its tax savings to plaintiff.

POINT III

The grounds upon which the District Court dismissed the action were erroneous.

The District Court predicated dismissal upon three grounds which we shall discuss in order:

1. It thought that defendant's tax saving improperly deprived the Government of taxes due it and that this injustice should not be compounded by distributing defendant's illegal gain to others (A, *infra*);

2. It conceived plaintiff's claim as an attempt by plaintiff to secure part of defendant's income in contravention of its reorganization plan (B, *infra*); and

3. It intimated that plaintiff was under a firm obligation to save defendant's taxes by filing consolidated returns (C, *infra*).

A

Plaintiff's alleged inability to recover because of the injustice of defendant's tax saving.

We submit that this ground of the decision below cannot stand, for several reasons.

1. *The Government had no tax claim.*

It would seem unquestionable that plaintiff's stock loss fell within the definition of § 23(g) (4). If, for instance, plaintiff had realized taxable operating income in 1943, no one would doubt that such income could have been offset by plaintiff's stock loss.

Nor can it be denied that plaintiff and defendant were affiliates within the purview of § 141(a), entitled to file consolidated returns. The fact that defendant's stock held by plaintiff had become worthless, was no obstacle to consolidated returns, as is demonstrated by cases such as

Burnet v. *Aluminum Goods Mfg. Co.*, 287 U. S. 544 (1932);
George A. Fuller Co. v. *Commissioner*, 92 F. 2d 72 (C. C. A. 2, 1937);
Trinity Buildings Corp. v. *Commissioner*, 40 B. T. A. 1315 (1939).

The two latter cases are fully discussed in plaintiff's brief. In the *Aluminum Goods* case, *supra*, the taxpayer had filed a consolidated return for the year 1917 covering itself and a subsidiary. The subsidiary had long been

insolvent, was liquidated in 1917 and dissolved in early 1918. The taxpayer claimed the loss of its investment in the subsidiary as a deduction for 1917. The Commissioner disallowed the deduction on the ground that it arose from an "inter-company transaction" between affiliated corporations, which must be ignored in a consolidated return. The Circuit Court of Appeals overruled the Commissioner because it thought that the subsidiary's insolvency and liquidation had *de facto* terminated the affiliation, although the parent still held title to the subsidiary's stock; "it would be a legal and commercial impossibility for a going corporation to affiliate with a corpse", *Aluminum Goods Mfg. Co.* v. *Commissioner,* 56 F. 2d 568, 571 (C. C. A. 7, 1932). But the Supreme Court, although affirming on other grounds, disapproved specifically the Circuit Court's reasoning and held that "since complete stock ownership is made the test of affiliation applicable here * * *, no ground is apparent for saying that the corporations ceased to be affiliated * * * " (287 U. S., at 548). Stock ownership as such, although economically worthless, was thus recognized as the statutory test of "affiliation"; and it was so recognized although the Supreme Court was aware that "the purpose of requiring consolidated returns" was to effectuate the affiliated group's status as "a single business enterprise" (287 U. S., at 547).

The *Aluminum Goods* case is significant for an additional reason: The taxpayer there, like the plaintiff here, used as a tax deduction the loss of the very stock which, at the same time, it used as a basis for establishing affiliation. The allowance of the deduction there was certainly no less "paradoxical" than the allowance of the similar deduction in the case at bar.

We submit, therefore, that, so far as the Government is concerned, there existed a substantial basis for the nonpayment of taxes for 1942-1944.

Indeed, the analysis here presented was not questioned by the Commissioner of Internal Revenue.* The District Court, nevertheless, rejected it as "plain stupidity" (R. 270); but the Court failed to assign any reason for this criticism and we believe that it was wholly unwarranted.

In any event, there is no need, at this late stage, to decide the question of tax liability *de novo;* for this question was settled between the Government and the parties. For present purposes it is enough to show a reasonable basis for the parties' claim that no taxes were due.

2. *The Government's tax claim has been validly and properly settled.*

Confronted with a substantial tax controversy, the Commissioner of Internal Revenue was certainly within his rights in consenting to a settlement. The District Court's suggestion that he "would not hesitate to set aside the tax settlement" if he had the power (R. 270), appears therefore gratuitous.

It is even more so because of the complete absence of any ground to impugn the legality or propriety of the settlement. The District Court did not find that the settlement was reached through fraud or corruption; and there is not

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* The Commissioner merely contended that plaintiff's loss had occurred in 1940, so that it was inadmissible as a deduction for the years 1942-1944 (R. 1423-4). But tax counsel argued persuasively that plaintiff's loss had not been ascertained until the Supreme Court's decision of March 15, 1943 (Pl. Ex. 64, R. 1779).

The Court below professed not to understand "how the alleged uncertainty as to the date of ascertainment of the stock loss could have been a true factor affecting the tax settlement, inasmuch as any such uncertainty would, if it existed, as well apply with respect to the 1943 and 1944 returns" (R. 267, fn. 8). Of course, it is true that the "uncertainty" applied to each of the years 1942, 1943 and 1944. Just because of this uncertainty the entire $21,000,000 tax amount for the three years was in controversy; and this controversy was ultimately compromised by the Government's retaining the $4,000,000 which it had already received and defendant's retaining the balance of $17,000,000. We fail to see how this arrangement could strike the Court below as implausible.

a shred of evidence which would support such finding. "The presumption of regularity supports the official acts of public officers and, in the absence of clear evidence to the contrary, courts presume that they have properly discharged their official duties"; *United States* v. *Chemical Foundation,* 272 U. S. 1, 14-15 (1926). This presumption, totally unrebutted here, is the answer to the District Court's unwarranted attack upon the settlement.

3. *Even if the tax settlement had been a wrong against the Government, it would not defeat plaintiff's rights.*

A hypothetical case will serve to make our point. Suppose that the executor of an estate, by improper means, collects an unjust claim of the estate or evades the payment of estate taxes justly due. Will it be suggested that he may retain the fruits of his illegal acts for himself? We believe that he would be accountable to his beneficiary for all profits derived in the course of his conduct as executor and that he cannot escape accountability by invoking his own wrongdoing. The present defendant, by virtue of its fiduciary duties to plaintiff, occupies no different position.

Indeed, the *Shreveport Bank* cases (*supra,* p. 35) so hold. There the procurement of the tax savings by the "new bank" constituted a plain wrong to the State of Louisiana. Nevertheless, the new bank was required to account for those tax savings to the old bank; and even Judge Waller, who originally dissented because the State had been "gypped" (144 F. 2d, at 245), subsequently joined the majority in permitting recovery of those tax savings which the new bank had secured for itself in the conduct of its fiduciary duties (176 F. 2d, at 1007-8, 1012-13).

4. *The District Court's pre-trial order, approving the parties' pre-trial stipulation, permits plaintiff to obtain at least the 1942 tax moneys.*

Even on the violent assumptions that the origin of defendant's tax savings was tainted and that the Court must

therefore "leave the parties where they are" (R. 276), it does not follow that plaintiff takes nothing. For purposes of this litigation, the 1942 tax moneys must be deemed in the possession of plaintiff; this is the basis upon which, under the parties' pre-trial stipulation and the District Court's pre-trial order (R. 163, 168), the case must be decided; hence, in order to "leave the parties where they are" or, more accurately, where they are deemed to be, plaintiff must be given the 1942 tax savings.

The origin and nature of the pre-trial stipulation and order have been previously described (*supra,* pp. 23-24, 25). Their substance is that this litigation shall be decided as though plaintiff's $4,201,821.54 refund claim (reduced by 4/21 thereof) had been allowed and paid by the Government to plaintiff. In other words, plaintiff is entitled, for purposes of the decision of this litigation, to be treated as though it had possession of $3,401,474.58 of the tax moneys in controversy. If the District Court felt impelled to "leave the parties where they are", it should at least have given effect to its own pre-trial order by putting plaintiff in possession of the 1942 tax moneys and then leaving the parties where they were.

B

The alleged inconsistency of plaintiff's claim with defendant's reorganization plan.

The District Court's reasoning runs: A "saving" in taxes actually means earnings not paid out to the Government. Plaintiff's claim is therefore a demand for a share of defendant's earnings; and the assertion by plaintiff of such a claim "is a circuitous way of obtaining something in the nature of equity or value for its ownership [of defendant's stock], rejected in the reorganization plan" (R. 272-4).

The fallacy of this reasoning lies in the confusion of what plaintiff is entitled to get by virtue of its stock ownership in defendant; and what it is entitled to get by virtue of defendant's use of plaintiff's tax credit.

It is perfectly true that defendant's reorganization plan precluded plaintiff from any share in defendant's assets or earnings based upon plaintiff's ownership of stock in defendant. That stock was wiped out by defendant's reorganization plan; and plaintiff was left, at this point, without right or interest in defendant's assets and earnings.

But after this was done—indeed, because it was done—plaintiff had a tax credit. The tax credit belonged to plaintiff; it did not belong to defendant. Defendant's reorganization plan, and the orders approving and confirming it, may be searched from A to Z; no breath of a suggestion will be found that plaintiff's tax credit must be made available to defendant.*

Plaintiff did make its tax credit available to defendant; defendant caused it to do so. This was a new transaction not contemplated by the reorganization plan. Plaintiff's claim stems from this new transaction; for, we say, plaintiff was in fairness entitled to the benefits from defendant's use of plaintiff's tax credit. By no stretch of argument may plaintiff's claim be viewed as based on its previous stock ownership in defendant.

Indeed, this is graphically demonstrated by the sequence of events. The consolidated returns and the refund claim were filed between July 15, 1944 and June 15, 1945. Prior to any of these dates—on April 30, 1944—plaintiff had surrendered its stock in defendant to the reorganization committee. Plaintiff was therefore no longer a stockholder of defendant at the time the tax returns and the refund claim were filed. Whatever rights plaintiff has in connection with these events, they cannot stem from its stock ownership in defendant which, at that time, was nonexistent. It follows that plaintiff's present claim, based upon the use of its tax credit by defendant, does not contravene the provisions of the reorganization plan eliminating plaintiff's stock interest in defendant.

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* The plan could contain no such suggestion. It was formulated in 1939 and approved in 1940 (R. 259). But the statutory amendment which made the tax credit possible—Internal Revenue Code, § 23(g)(4)—was not enacted until 1942.

C

Plaintiff's alleged obligation to save defendant's taxes by filing consolidated returns.

The District Court did not state the ground upon which it considered plaintiff obligated to file consolidated returns so as to save defendant's taxes (R. 275). Defendant itself advanced two reasons.

1. *Plaintiff's alleged fiduciary duty to defendant.*

In the first place, defendant said that plaintiff owned all of defendant's stock; that this stock ownership placed upon plaintiff a fiduciary duty to safeguard defendant against detriment; and that plaintiff would have violated this fiduciary obligation by refusing to join in consolidated returns which would minimize defendant's taxes.

Premise and conclusion of this argument are equally faulty.

(a) To begin with, plaintiff was no longer a stockholder of defendant during the critical period from July 1944 to June 1945; it had surrendered the stock in April 1944. Moreover control, rather than stock ownership, has been held to be the basis of fiduciary obligations (*Southern Pacific Co.* v. *Bogert, supra,* 250 U. S., at 492); and plaintiff certainly had no control of defendant or its court-appointed trustees. On both counts defendant's argument to establish fiduciary duties of plaintiff is untenable.

(b) But even if plaintiff had been a fiduciary, it was under no obligation to file consolidated returns and make its tax credit available to defendant. The tax credit, as we have shown (*supra,* pp. 55-57), was a thing of value. A fiduciary is held to the highest standards of honesty in dealing with his cestui; but he certainly is not required to donate his own property to the cestui. Plaintiff's tax credit was its own, not defendant's; and if plaintiff

"decided that its best interests required filing by it of a separate tax return, no provision of the law denied it this privilege * * *."

Duke Power Co. v. *Commissioner, supra,* 44 F. 2d, at 545.

Moreover, by filing consolidated returns plaintiff subjected itself to joint and several liability for any taxes or tax deficiencies which might be assessed on defendant's income (Treas. Reg. 104, § 23.15(d)). It is not a fiduciary's duty to make himself the surety for his cestui's tax obligations.

(c) In any event, if plaintiff was under a fiduciary duty to defendant, defendant was under no less an obligation to plaintiff. The duality of management and defendant's control of the tax transactions created this obligation. Defendant's argument thus leads, at most, to the conclusion that both parties were required to deal fairly with each other. Nowhere has defendant shown that fair dealing permitted it to retain the tax savings derived from plaintiff's tax credit. On the contrary, in the light of the purpose of the tax laws to mitigate plaintiff's stock loss and to benefit it as the parent of the affiliated group, fairness entitled plaintiff at least to a fair share of the tax savings produced by the joint action of the parties.

2. *Plaintiff's alleged obligation under the bankruptcy laws.*

Defendant's second argument is predicated upon its bankruptcy reorganization. Defendant, as the debtor in reorganization, was obligated to preserve its assets for the benefit of creditors. Plaintiff, as its stockholder, was under the same duty by virtue of § 7(b) of the Bankruptcy Act, 11 U. S. C. § 25(b). From this obligation defendant concludes that plaintiff was required to preserve defendant's estate by minimizing its tax through the filing of consolidated returns.

(a) Again this argument overlooks that, at the time the consolidated returns and the refund claim were filed, plaintiff was no longer a stockholder of defendant. § 7(b) of the Bankruptcy Act was therefore inapplicable; hence defendant's bankruptcy imposed no duty on plaintiff to preserve defendant's assets.

(b) Again, even if it were assumed that plaintiff was under an obligation to preserve defendant's assets because of its bankruptcy, yet certainly plaintiff was under no duty to donate its tax credit to defendant. It is true that plaintiff's tax credit could be of great value to defendant; but does it follow that plaintiff was obligated to make a gift of it to defendant? If plaintiff had been the owner, say, of rolling stock useful to defendant, no one would argue that defendant's need, or its bankruptcy, created an obligation of plaintiff to donate its property to defendant. No better ground exists for defendant's contention that plaintiff was obligated, because of defendant's bankruptcy, to donate its tax credit to defendant and, on top of that, by joining in consolidated returns, to make itself jointly and severally liable for defendant's tax debts.

(c) Furthermore, any obligation on plaintiff's part to preserve defendant's assets did not include the duty to confer upon defendant a tax saving which, by the very purpose of the tax laws was designed for plaintiff, not for defendant. The purpose of the tax laws was to mitigate plaintiff's stock loss, not to give defendant an undeserved and unmotivated tax advantage; and this statutory purpose was not changed by defendant's bankruptcy.

(d) Finally, it might be noted that the 1944 returns and the 1942 refund claim were filed in 1945, long after defendant had emerged from reorganization. No argument based on defendant's bankruptcy can apply to transactions made after the bankruptcy had ended.

We submit that the decision below cannot be sustained because of the alleged obligation of plaintiff to join in consolidated returns.

Conclusion

It is respectfully submitted that the judgment of the District Court should be reversed and that this Court should grant judgment for plaintiff in the amount of defendant's tax savings or, at least, of such part thereof as to this Court may appear fair in the circumstances of this case.

Dated: San Francisco, Calif., September 14, 1950.

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APPENDIX

TEXT OF STATUTES AND REGULATIONS CITED

Bankruptcy Act, § 7, 11 U. S. C., § 25

DUTIES OF BANKRUPTS

a. The bankrupt shall (1) attend at the first meeting of his creditors, at the hearing upon objections, if any, to his application for a discharge and at such other times as the court shall order; (2) comply with all lawful orders of the court; (3) examine and report to his trustee concerning the correctness of all proofs of claim filed against his estate; (4) execute and deliver such papers as shall be ordered by the court; (5) execute and deliver to his trustee transfers of all his property in foreign countries; (6) immediately inform his trustee of any attempt by his creditors or other persons to evade the provisions of this title coming to his knowledge; (7) in case of any person having to his knowledge proved a false claim against his estate, disclose that fact immediately to his trustee; (8) prepare, make oath to, and file in court within five days after adjudication, if an involuntary bankrupt, and with his petition, if a voluntary bankrupt, a schedule of his property, showing the amount and kind of property, the location thereof and its money value, in detail; and a list of all his creditors, including all persons asserting contingent, unliquidated, or disputed claims, showing their residence, if known, or if unknown that fact to be stated, the amount due to or claimed by each of them, the consideration thereof, the security held by them, if any, and what claims, if any, are contingent, unliquidated, or disputed; and a claim for such exemptions as he may be entitled to; all in triplicate, one copy for the clerk, one for the referee, and one for the trustee: *Provided*, That the court may for cause shown grant further time for the filing of such schedules if, with his petition in a voluntary proceeding or with his applica-

tion to have such time extended in an involuntary proceeding, the bankrupt files a list of all such creditors and their addresses; (9) file in triplicate with the court at least five days prior to the first meeting of his creditors a statement of his affairs in such form as may be prescribed by the Supreme Court; (10) at the first meeting of his creditors, at the hearing upon objections, if any, to his discharge and at such other times as the court shall order, submit to an examination concerning the conducting of his business, the cause of his bankruptcy, his dealings with his creditors and other persons, the amount, kind, and whereabouts of his property, and, in addition, all matters which may affect the administration and settlement of his estate or the granting of his discharge; but no testimony given by him shall be offered in evidence against him in any criminal proceeding, except such testimony as may be given by him in the hearing upon objections to his discharge: *Provided, however,* That when the bankrupt is required to attend for examination, except at the first meeting and at the hearing upon objections, if any, to his discharge, he shall be paid actual and necessary traveling expenses for any distance in excess of one hundred miles from his place of residence at the date of bankruptcy: *And provided further,* That the court may for cause shown, and upon such terms and conditions as the court may impose, permit the bankrupt to be examined at such place as the court may direct whether within or without the district in which the proceedings are pending; and (11) when required by the court, prepare, verify, and file with the court in duplicate a detailed inventory, showing the cost to him of his merchandise or of such other property as may be designated, as of the date of his bankruptcy.

b. Where the bankrupt is a corporation, its officers, the members of its board of directors or trustees or of other similar controlling bodies, its stockholders or members, or such of them as may be designated by the court, shall perform the duties imposed upon the bankrupt by this title.

Internal Revenue Code

§ 23. *Deductions from gross income.* In computing net income there shall be allowed as deductions: * * *

(g) Capital losses.

(1) Limitation. Losses from sales or exchanges of capital assets shall be allowed only to the extent provided in section 117.

(2) Securities becoming worthless. If any securities (as defined in paragraph (3) of this subsection) become worthless during the taxable year and are capital assets, the loss resulting therefrom shall, for the purposes of this chapter, be considered as a loss from the sale or exchange, on the last day of such taxable year, of capital assets.

(3) Definition of securities. As used in paragraph (2) of subsection the term "securities" means (A) shares of stock in a corporation, and (B) rights to subscribe for or to receive such shares.

(4) Stock in affiliated corporation. For the purposes of paragraph (2) stock in a corporation affiliated with the taxpayer shall not be deemed a capital asset. For the purposes of this paragraph a corporation shall be deemed to be affiliated with the taxpayer only if:

(A) at least 95 per centum of each class of its stock is owned directly by the taxpayer; and

(B) more than 90 per centum of the aggregate of its gross incomes for all taxable years has been from sources other than royalties, rents (except rents derived from rental of properties to employees of the company in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, or gains from sales or exchanges of stocks and securities; and

(C) the taxpayer is a domestic corporation.

§ 122. Net operating loss deduction

(a) Definition of net operating loss. As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

(b) Amount of carry-back and carry-over.

(1) Net operating loss carry-back. If for any taxable year beginning after December 31, 1941, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-back for each of the two preceding taxable years, except that the carry-back in the case of the first preceding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the second preceding taxable year computed (A) with the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4), and (6), and (B) by determining the net operating loss deduction for such second preceding taxable year without regard to such net operating loss.

(2) Net operating loss carry-over. If for any taxable year the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-over for each of the two succeeding taxable years, except that the carry-over in the case of the second succeeding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the intervening taxable year computed (A) with the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4), and (6), and (B) by determining the net operating loss deduction for such intervening taxable year without regard to such net operating loss and without regard to any net operating loss carry-back. For the purposes of the preceding sentence, the net operating loss for any taxable year beginning after December 31, 1941 shall be reduced by the sum of the net income for each of the two preceding taxable years (computed for each such preceding taxable year with

the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4), and (6), and computed by determining the net operating loss deduction without regard to such net operating loss or to the net operating loss for the succeeding taxable year).

§ 129. Acquisitions made to evade or avoid income or excess profits tax

(a) Disallowance of deduction, credit, or allowance. If (1) any person or persons acquire, on or after October 8, 1940, directly or indirectly, control of a corporation, or (2) any corporation acquires, on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately prior to such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation, and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income or excess profits tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed. For the purposes of clauses (1) and (2), control means the ownership of stock possessing at least 50 per centum of the total combined voting power of all classes of stock entitled to vote or at least 50 per centum of the total value of shares of all classes of stock of the corporation.

(b) Power of Commissioner to allow deduction, etc., in part. In any case to which subsection (a) is applicable the Commissioner is authorized—

(1) to allow as a deduction, credit, or allowance any part of any amount disallowed by such subsection, if he determines that such allowance will not result in the evasion or avoidance of Federal income and excess profits tax for which the acquisition was made; or

(2) to distribute, apportion, or allocate gross income, and distribute, apportion, or allocate the deductions, credits, or allowances the benefit of which was sought to be secured, between or among the corporations, or properties, or parts thereof, involved, and to allow such deductions, credits, or allowances so distributed, apportioned, or allocated, but to give effect to such allowance only to such extent as he determines will not result in the evasion or avoidance of Federal income and excess profits tax for which the acquisition was made: or

(3) to exercise his powers in part under paragraph (1) and in part under paragraph (2).

§ 141. Consolidated returns

(a) Privilege to file consolidated income and excess-profits-tax returns. An affiliated group of corporations shall, subject to the provisions of this section, have the privilege of making consolidated income and excess-profits-tax returns for the taxable year in lieu of separate returns. The making of consolidated returns shall be upon the condition that the affiliated group shall make both a consolidated income-tax return and a consolidated excess-profits-tax return for the taxable year, and that all corporations which at any time during the taxable year have been members of the affiliated group making a consolidated income-tax return consent to all the consolidated income- and excess-profits-tax regulations prescribed under subsection (b) prior to the last day prescribed by law for the filing of such return. The making of a consolidated income-tax return shall be considered as such consent. In the case of a corporation which is a member of the affiliated group for a fractional part of the year, the consolidated returns shall include the income of such corporation for such part of the year as it is a member of the affiliated group. In the case of a corporation which is not a member of the affiliated group after March 31, 1942, of the last taxable year of such group which begins before April 1, 1942, such cor-

poration shall not be considered a member of the affiliated group for consolidated income-tax-return purposes for such year but shall be considered a member of such group for consolidated excess-profits-tax-return purposes for such year, and the consent required in the case of such corporation shall relate only to the consolidated excess-profits-tax regulations.

(b) Regulations. The Commissioner, with the approval of the Secretary, shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making consolidated income- and excess-profits-tax returns and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income- and excess-profits-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability. Such regulations shall prescribe the amount of the net operating loss deduction of each member of the group which is attributable to a deduction allowed for a taxable year beginning in 1941 on account of property considered as destroyed or seized under section 127 (relating to war losses), and the allowance of the amount so prescribed as a deduction in computing the net income of the group shall not be limited by the amount of the net income of such member.

(c) Computation and payment of tax. In any case in which consolidated income-tax and excess-profits-tax returns are made or are required to be made, the taxes shall be determined, computed, assessed, collected, and adjusted in accordance with the regulations under subsection (b) prescribed prior to the last day prescribed by law for the filing of such returns; except that the tax imposed under section 15 or section 204 shall be increased by 2 per centum of the consolidated corporation surtax net income of the affiliated group of includible corporations. Only one spe-

cific exemption of $10,000 provided in section 710(b) (1) shall be allowed for the entire affiliated group of corporations for the purposes of the tax imposed by Subchapter E of Chapter 2.

(d) Definition of "affiliated group". As used in this section, an "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if—

(1) Stock possessing at least 95 per centum of the voting power of all classes of stock and at least 95 per centum of each class of the nonvoting stock of each of the includible corporations (except the common parent corporation) is owned directly by one or more of the other includible corporations; and

(2) The common parent corporation owns directly stock possessing at least 95 per centum of the voting power of all classes of stock and at least 95 per centum of each class of the nonvoting stock of at least one of the other includible corporations.

As used in this subsection, the term "stock" does not include nonvoting stock which is limited and preferred as to dividends.

(e) Definition of "includible corporation". As used in this section, the term "includible corporation" means any corporation except—

(1) Corporations exempt under section 101 from the tax imposed by this chapter.

(2) Insurance companies subject to taxation under section 201 or 207.

(3) Foreign corporations.

(4) Corporations entitled to the benefits of section 251, by reason of receiving a large percentage of their income from sources within possessions of the United States.

(5) Corporations organized under the China Trade Act, 1922.

(6) Regulated investment companies subject to tax under Supplement Q.

(7) Any corporation described in section 725(a), or in section 727 (c), (g), or (h) (without regard to the exception in the initial clause of section 727) but not including such a corporation which has made and filed a consent, for the taxable year or any prior taxable year beginning after December 31, 1943, to be treated as an includible corporation. Such consent shall be made and filed at such time and in such manner as may be prescribed by the Commissioner with the approval of the Secretary.

(f) Includible insurance companies. Despite the provisions of paragraph (2) of subsection (e), two or more domestic insurance companies each of which is subject to taxation under the same section of this chapter shall be considered as includible corporations for the purpose of the application of subsection (d) to such insurance companies alone.

(g) Subsidiary formed to comply with foreign law. In the case of a domestic corporation owning or controlling, directly or indirectly, 100 per centum of the capital stock (exclusive of directors' qualifying shares) of a corporation organized under the laws of a contiguous foreign country and maintained solely for the purpose of complying with the laws of such country as to title and operation of property, such foreign corporation may, at the option of the domestic corporation, be treated for the purpose of this chapter and of Subchapter E of Chapter 2 as a domestic corporation.

(h) Suspension of running of statute of limitations. If a notice under section 272(a) in respect of a deficiency for any taxable year is mailed to a corporation, the suspension of the running of the statute of limitations, provided in section 277, shall apply in the case of corporations with

which such corporation made a consolidated return for such taxable year.

(i) Allocation of income and deductions. For allocation of income and deductions of related trades or businesses, see section 45.

Securities and Exchange Commission Rule U-45

(a) General provision.—No registered holding company or subsidiary company shall, directly or indirectly, lend or in any manner extend its credit to nor indemnify, nor make any donation or capital contribution to, any company in the same holding company system, except pursuant to a declaration notifying the Commission of the proposed transaction, which has become effective in accordance with the procedure specified in Rule U-23, and pursuant to the order of the Commission with respect to such declaration under the applicable provisions of the Act.

(b) Exceptions.—The following transactions shall be exempt from the declaration requirements of this rule:

* * * *

(6) A loan or extension of credit or an agreement of indemnity arising out of a consolidated tax return filed by a holding company (or other parent company) and its subsidiaries: Provided, That the top company in the group assumes primary responsibility for the payment of any tax liability involved, subject to the right to contribution from the several members of the group in an amount not exceeding as to any company that percentage of the sum of the normal tax, surtax, and an excess profits tax on a consolidated basis which the sum of the normal tax, surtax and excess profits tax of such company if paid on a separate return basis is of the aggregate amount of normal, surtax and excess profits taxes of the individual companies based upon separate returns. In each instance the amount

of excess profits tax shall be computed less the amount of the post-war refund. In computing each company's tax on a separate return basis, allowance shall be made for loss carry-over and other adjustments as if the company had always filed its tax return on a separate return basis. The amount of post-war refund bonds which the consolidated group will acquire (under Section 780 of the Internal Revenue Code) and the liability therefor shall be allocated to the several members of the group in the ratio that the post-war refund bonds each company would acquire on a separate return basis bears to the sum of the post-war refund bonds which all of the companies would acquire on the basis of separate tax returns.

Treasury Regulation 104

§ 23.12:

(a) A consolidated return shall be made on Form 1120 by the common parent corporation for the affiliated group. Such return shall be filed at the time and in the office of the collector of the district prescribed for the filing of a separate return by such corporation.

(b) Each subsidiary must prepare duplicate originals of Form 1122, consenting to these regulations and authorizing the common parent corporation to make a consolidated return on its behalf for the taxable year and authorizing the common parent (or, in the event of its failure, the Commissioner or the collector) to make a consolidated return on its behalf (as long as it remains a member of the affiliated group), for each year thereafter for which, under section 23.11 (*a*), the making of a consolidated return is required. One of such forms as prepared by each subsidiary shall be attached to the consolidated return, as a part thereof; and the other shall be filed, at or before the time the consolidated return is filed, in the office of the collector for the district prescribed for the filing of a separate re-

turn by such subsidiary. No such consent can be withdrawn or revoked at any time after the consolidated return is filed.

The filing of Form 1122 for a taxable year beginning after December 31, 1943, by a subsidiary which is either a personal service corporation as described in section 725(a) or a corporation described in section 727 (e), (g), or (h) shall constitute the making and filing of its consent to be treated as an includible corporation under section 141(e)(7).

If the common parent corporation is a personal service corporation as described in section 725(a) or a corporation described in section 727 (e), (g), or (h), the making and filing of the consolidated income tax return for a taxable year beginning after December 31, 1943, shall constitute the making and filing of its consent to be treated as an includible corporation under section 141(e)(7).

A corporation which consents to be treated as an includible corporation for a taxable year beginning after December 31, 1943, shall be treated as an includible corporation for all subsequent years, regardless of whether the affiliated group of which such corporation is a member during such subsequent years is the same as the affiliated group of which such corporation was a member when such consent was filed. No consent to be treated as an includible corporation under section 141(e)(7) can be withdrawn or revoked at any time after the consolidated return is filed for the first taxable year for which the consent is filed.

§ 23.15:

(a) Except as provided in paragraph (*b*), the common parent corporation and each subsidiary, a member of the affiliated group during any part of a consolidated return period, shall be severally liable for the tax (including any deficiency in respect thereof) computed upon the consolidated net income of the group.

(b) If, at the time of filing a consolidated return, one or more, but not all, of the members of the affiliated group are in bankruptcy under the laws of the United States or in receivership in any court of the United States or of any State, Territory, or the District of Columbia, then the liability under paragraph (*a*) of each such member of the group with respect to the period covered by such return shall not exceed such portion of the consolidated tax liability for such period as the several corporations included in the consolidated return may, subject to the approval of the Commissioner, agree upon, or, in the absence of such an agreement, an amount equal to its liability for such year computed as if a separate return had been filed.

(c) If a subsidiary has ceased to be a member of the affiliated group, its liability under paragraph (*a*) shall remain unchanged, except that if such cessation occurred prior to the date upon which any deficiency is assessed and resulted from a bona fide sale of stock for fair value, the Commissioner may, if he believes that the assessment or collection of the balance of the deficiency will not be jeopardized, make assessment and collection of such deficiency from such former subsidiary in an amount not exceeding the portion thereof allocable to it upon the basis of income used in the computations respectively of the normal tax and any surtaxes included in such deficiency.

(d) Any agreement entered into by one or more members of the affiliated group with any other members of such group or with any other person shall in no case have the effect of reducing the liability prescribed under this section.

§ 23.16:

(a) The common parent corporation shall be for all purposes, in respect of the tax for the taxable year for which a consolidated return is made or is required, the sole agent, duly authorized to act in its own name in all matters relating to such tax, for each corporation which during any part

of such year was a member of the affiliated group. The corporations, other than the common parent, shall not have authority to act for or to represent themselves in any such matter. For example, all correspondence will be carried on directly with the common parent; notices of deficiencies will be mailed only to the common parent, and the mailing to the common parent shall be considered as a mailing to each such corporation; notice and demand for payment of taxes will be given only to the common parent, and such notice and demand shall be considered as a notice and demand to each such corporation; the common parent will file petitions and conduct proceedings before the Board of Tax Appeals, and any such petition shall be considered as having also been filed by each such corporation; the common parent will file claims for refund or credit; refunds will be made directly to and in the name of the common parent and will discharge any liability of the Government in respect thereof to any such corporation; and the common parent in its name will give waivers, give bonds, and execute closing agreements, offers in compromise, and all other documents, and any waiver or bond so given, or agreement, offer in compromise, or any other document so executed, shall be considered as having also been given or executed by each such corporation. Notwithstanding the provisions of this paragraph, however, any notice of deficiency, in respect of the tax for a consolidated return period, will name each corporation which was a member of the affiliated group during any part of such period, and any assessment (whether of the original tax or of a deficiency) will be made in the name of each such corporation (but a failure to include the name of any such corporation will not affect the validity of the notice of deficiency or the assessment as to the other corporations); any notice and demand for payment will name each corporation which was a member of the affiliated group during any part of such period (but a failure to include the name of any such corporation will not affect the validity of the notice and demand as to the

other corporations); and any distraint (or warrant in respect thereof), any levy (or notice in respect thereof), any notice of a lien, or any other proceeding to collect the amount of any assessment, after the assessment has been made, will name the corporation from which such collection is to be made. The provisions of this paragraph shall apply whether or not a consolidated return is made for any subsequent year, and whether or not one or more subsidiaries have become or have ceased to be members of the group at any time. Notwithstanding the provisions of this paragraph, the Commissioner may, if he deems it advisable, deal directly with any member of the group in respect of its liability, in which event such member shall have full authority to act for itself.